

THE NEW YORK

Certified Public Accountant

THE STATE SOCIETY'S 60TH YEAR

BENJAMIN NEWMAN, *Managing Editor*

EDITORIAL BOARD

RAYMOND G. ANKERS, *Chairman*

JOSEPH A. DOWLING
GEORGE N. FARRAND
MITCHELL FASTOW
RICHARD S. HELSTEIN

WILLIAM C. KNAUF
COLIN PARK
SAMUEL J. SHERMAN
REUBEN WESTERMAN

VOL. XXVII

April • 1957

No. 4

• The President's Page—Arthur B. Foye, C.P.A.	239
• Should the Standards of Accreditation for the CPA Certificate Be Revised?— Arthur B. Foye, C.P.A.	241
• A Summary Appraisal of the Commission's Recommendations— Emanuel Saxe, C.P.A.	245
• Tax Status of Partnerships—Herman H. Cohen, C.P.A.	250
• Retirement or Death of a Partner—Arthur J. Dixon, C.P.A.	258
• Problems of Perpetuating the Small Business Entity— Llewellyn L. Rogers, C.P.A.	262
• Norman Edward Webster—The Committee on History	266
• Departments—	
Accounting News and Trends—Charles L. Savage, C.P.A.	220
Letters to the Editor	228
An Adirondack View—Leonard Houghton, C.P.A.	231
Book Reviews	232
New York State Tax Forum—Benjamin Harrow, C.P.A.	271
Accounting at the SEC—Louis H. Rappaport, C.P.A.	274
Administration of a CPA Practice—Max Block, C.P.A.	281
Payroll Tax Notes—Samuel S. Ress	284
Federal Income Tax Notes—Richard S. Helstein, C.P.A.	286

Society and Editorial Offices: 677 Fifth Avenue, New York 22, N. Y.
(Copyright, 1957, by The New York State Society of Certified Public Accountants)

The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.

Accounting News And Trends

Improving the Readability of Reports

In his article "Presentation of Reports on Commercial Engagements" (*California Certified Public Accountant*, February 1957), Mr. J. A. Campbell makes a number of suggestions for the elevation of what he terms standards of presentation and readability of accountants' reports.

Uncrowded pages with short paragraphs and frequent side captions are distinct aids to easy reading. Simple charts or tables requiring no special training to prepare, often are most effective in making points and could easily be included. Even the size of the reports might be improved because many are prepared on 9" x 12" or even 8½" x 14" sheets while the client's files are made for 8½" x 11" material. Reports are thus often "tucked away" in less accessible places.

The color of the report cover is also commented upon. After referring to the tradition in most firms of always using a cover of the same color, the author suggests that a different color be used when the content is something other than the usual certificate or long form report. This change might subtly suggest the scope limitation of the special work.

The language of the report should be as close to "laymen's language" as practicable because that is the only way to reach the reading audience. The greater the use of technical terms the narrower the appeal. The use of simple, forceful language is particularly necessary when presenting systems recommendations because this type of report must do a selling job. In such cases both the arguments and the words must be selected with care.

There are a few items which appear frequently in reports which the author thinks could very well be omitted. The description of the scope of the examination is an example. Because the accountant is best

qualified to gauge the adequacy of the scope of the audit there is no need for repeating the basis of his thinking for others to pass on. Mr. Campbell criticizes the practice of presentation of comparisons without adequate explanation. A mere statement that sales have increased 15% adds nothing to the statement unless the reasons—a price increase, new product, greater sales effort, etc.—are set forth.

The CPA as Public Speaker

A reprint of an article by Julian O. Phelps, originally published in *The Illinois Certified Public Accountant* (June 1955), contains some helpful hints for the accountant who may be called upon as a public speaker.

1. Do not read a paper. Use notes if you must, but no written material at all would be best. If you stumble a little, no harm is done and you probably will create a sympathetic feeling with your audience. Keep your eyes on your listeners and be guided by the wandering or puzzled looks that appear.
2. Prepare carefully. Make an outline and assemble your facts. Practice in private, before a mirror if you wish. Try your talk on your wife and the resulting embarrassment will be very helpful.
3. Use examples more than principles. A good practice is to first use a simple example, then state the principle it illustrates and conclude with another example to clinch the point.
4. Do not cover too many subjects. Select the most important and really explain them. Limit your talk to about one half hour.
5. A little humor will relax you and your listeners. A bit of thought can often enable you to give a humorous twist to some of your material and this will better serve your purpose than a joke about the traveling salesman.
6. Distribute a mimeographed outline of your talk. It aids your audience in following the presentation and is a convenient place for making notes.
7. If you are asked for a paper, stall the request until after the meeting. Dictate your speech after you have given it and you will be surprised at its readability.
8. Finally, do not underestimate your task.

Accounting News and Trends is conducted by CHARLES L. SAVAGE, C.P.A. and member of the New York Bar. He is presently serving on the Board of Directors of the Nassau-Suffolk Chapter of our Society.

Dr. Savage is professor of accounting and chairman of the Business Administration Department of Adelphi College.

One standard is about one hour of preparation for each minute of delivery.

Embezzlers — Postwar

In "Rx Embezzlement" (*The Controller*, January 1957), William Phelan points out some changes in the background of current embezzlers. For many years accountants have known that the typical embezzler is 36 years old, married with two children, good community position, etc. This knowledge was based on a well publicized study of the U. S. Fidelity and Guaranty Company in 1936.

A new study, published in 1950, shows that the composite embezzler has changed somewhat. Now he is younger, earns much more money, is less often married, and has fewer dependents than his counterpart of 15 years ago. His character and past record are less favorable. He lives faster, has worked fewer years for his employer and is more apt to abscond than to commit suicide.

The protection against embezzlers has changed less than the individuals and it is surprising how many executives continue to disregard these three-pronged safeguards:

"1. Establishment of an adequate system of internal control, and subsequent continuing supervision to insure adherence to the system.

2. Engagement of independent auditors for periodic examinations.

3. Purchase of adequate fidelity bond protection from any reputable bonding company."

Real Estate Accounting Bibliography

The Committee on Real Estate Accounting has recently prepared a comprehensive bibliography in the field of real estate accounting and taxation. A limited number of copies are available to interested members of our Society.

Pitfalls In Financial Statement Analysis

Two related articles on the banker's role in analyzing financial statements preparatory to granting credit appear in the *Bulletin Of The Robert Morris Associates* (January and February 1957). The first, by Bentley J. McCloud, Jr. (January 1957), is entitled "Pitfalls in Statement Analysis" and some of the caveats contained therein are of interest to the CPA. To avoid the first pitfall, the banker should scrutinize the auditor's certificate closely to determine if an

unqualified opinion is expressed and if not, why it is omitted or qualified. If the receivables and inventories are of significant amounts, the former should have been confirmed and the normal procedures of observing the count and checking the valuation of the latter should have been followed. As a final safeguard, the banker should seek information about the auditing firm and its standing in the profession.

Another pitfall against which bankers should be on the alert is the idea that financial statements are always definitive presentations and the value of the dollar constant. In an inflationary period, increased dollar sales volume could represent lesser unit volume, and depreciation charged on historical cost may be deceptively low.

The third pitfall is to avoid the idea that the balance sheet remains unchanged after the credit has been extended. Conditions sometimes change rapidly and interim financial statements are highly desirable where the credit extended is liberal in relation to working capital and net worth. In the latter situation a cash budget is helpful because it points up the peak seasonal credit requirements and indicates when the borrower will be able to liquidate the debt. Finally, it is emphasized that financial statements, dealing as they must with past activities, are no substitute for personal contact and investigation in seeking to judge the competence of management and its resourcefulness in meeting change. A good credit man will make personal visits at least once a year to his customer's place of business. If the company is dominated by a strong chief executive, particular attention should be given to the second level of management.

Analysis of the Trial Balance

The second article, by Herman Chirlian (February 1957), is entitled "Limitations and Procedures in Analysis of the Trial Balance" and carries forward the ideas suggested by the third pitfall listed above. The author points out that today's credit situation cannot be checked on information which is six-months old. Since most firms do not prepare quarterly or semi-annual financial statements, the trial balance has become the medium for obtaining the latest financial information. The use of the trial balance would be simplified if it could be accepted without any doubts as to its accuracy, but such factors as the skill of the bookkeeper who prepared it, the adequacy of the sys-

BRUNING
Reproduction of
TAX RETURNS
AND REPORTS

Done by Experts

Accurate and
Attractive
TYPING

Of Accountants' Reports
Thoroughly Checked
Highly Skilled
Personalized Service

Since 1940

LILLIAN SAPADIN

501 Fifth Ave., New York 17, N. Y.
 MUrray Hill 2-5346



DOES TIGHT MONEY
HAVE YOUR CLIENTS
IN A SQUEEZE?

We offer Accounts Receivable financing . . . Mortgage financing . . . Inventory loans . . . to help ease this squeeze.

For a professional approach to working capital requirements . . . work with a firm that understands your problems and your clients' problems. Consultation in strict confidence.

Call for Bulletin A: "How a CPA Can Improve His Clients' Financial Position."

FUNDS FOR BUSINESS, INC.
Commercial Financing

120 East 41st St. New York 17, N. Y.
 LExington 2-3916

tem of internal check, and the motives of the customer may result in certain errors of omission, commission, or principle.

The author then discusses certain of these errors, some of which are worthy of comment. The accounts receivable on the trial balance may be in excess of the actual accounts receivable shown in the customer's ledger. It often contains such items as advances to firm members, salesmen's over-drafts, and loans to relatives or affiliated interests. When receivables appear excessive in relation to sales, some of these conditions may be inferred and additional information may be required.

Accrued liabilities may be substantial in amount but do not usually appear on the trial balance. It is difficult to estimate the accrued wages, salaries, commissions, taxes, etc., but the amounts may be significant and it is important not to overlook making inquiry about these items.

The author also comments on the practice of computing a break-even inventory and presenting it as though the figures had conclusive meaning. He believes that since the concept of the break-even inventory is a variable one of relative value which might mislead the credit grantor, it should be used with extreme care.

CPA Candidates' Deficiencies—
A Familiar Ring

Some comments of examiners grading the Australian equivalent of our CPA examination, appear in *The Australian Accountant* for October, 1956. They have a familiar ring, particularly the first comment which is quoted directly:

"Poor English expression, incorrect spelling, and illegible writing are faults so common as to be serious."

The examiners go on to point out that the papers contain too many long dissertations with endless repetition and incongruous arguments showing a marked inability to marshal facts logically, and to present them in clear direct English. They rightly observe that there is no virtue in verbosity which is time-consuming and sometimes results in the oversight of some of the demands of a question. On the other hand, superficial answers are not good enough and vague or general terms are not sufficient. Vagueness in answers leads to an impression of doubt as to the candidate's knowledge.

The summary states that in many instances answers are obvious guesses, showing no evidence of reading or study. Many students

es of
errors

these
com-
trial
al ac-
omer's
is ad-
over-
iliated
cessive
ditions
nation

ial in
on the
te the
taxes,
nt and
ng in-

prac-
ry and
d con-
ce the
is a
might
e used

ng the
amina-
ountant
ur ring,
quoted

spell-
o com-

that the
trations
is argu-
marsh-
an clear
ve that
is time-
in the
a ques-
answers
general
in an-
st as to

stances
ing no
students

April

MARATHON CORPORATION
"NATION'S LEADING PRODUCER OF PAPER PRODUCTS
FOR FOOD PACKAGING AND HOUSEHOLD USE."



**"National Accounting Machines save us
\$20,000 a year...return 67% annually on our investment!"**

—MARATHON CORPORATION, Menasha, Wis.

"Research is the key that keeps our company ahead in the rapidly expanding pulp, paper, and paperboard industry.

"Because Marathon is 'many businesses in one,' our accounting requirements are complex. After a thorough research, we decided upon Nationals to meet our particular accounting needs.

"National Accounting Machines save us \$20,000 a year, returning 67% annually on our investment.

"We use Nationals for control of Payroll, Accounts Payable, Distribution and General Ledger.

Their versatility is amazing. We plan to adapt their facilities to produce even greater savings."

Emmett W. Below
Controller, Marathon Corporation

THE NATIONAL CASH REGISTER COMPANY, DAYTON 9, OHIO
989 OFFICES IN 94 COUNTRIES

In your business, too, National machines will pay for themselves with the money they save, then continue savings as annual profit. Your nearby National man will gladly show you how. Or write to us at Dayton 9, Ohio.



ACCOUNTS RECEIVABLE LOANS

A unique Service for those of
your clients who can profitably
use additional Working Capital
in their business



LOWEST RATES ·
· NON-NOTIFICATION



Service Factors Company

450 7th Avenue M. Jolles
New York City La 4-7661-2

serving your clients over 20 years

BOOKKEEPERS UNLIMITED INC. AGENCY

DIRECTED BY A C. P. A.

RESPONSIBLE
EXPERIENCED
BOOKKEEPING
PERSONNEL
EXCLUSIVELY

299 MADISON AVE., NEW YORK 17
TELEPHONE: OXFORD 7-2237

rely on material memorized from a text book and show no understanding or evaluation of the concepts used. The examiners regret what appears to be a mechanical approach to the study of accountancy, and a general failure to grasp the sense or significance of figures appearing in accounts. Their conclusion is that little knowledge or appreciation of the importance of principles, conventions, or doctrines is displayed in answers.

Ethics—Positive vs. Negative

What are the obligations of an accountant who receives a referral of a special problem from another accountant and is then requested by the client to take over the entire engagement? What of the client who is "considering a change" and asks a new accountant to look over the records and submit a fee estimate? Should you offer a job to a promising accountant who has approached you for employment but has not yet notified his own employer? These are some of the many specific issues raised by Mr. A. B. Willis in *The California Certified Public Accountant* (November, 1956) in an article bearing the general title "Ethics."

In considering the first question, the author insists that each accountant must feel that he can entrust a client to a fellow member of the profession, and the accountant receiving the referral should make every effort to avoid taking over the account. In the second situation, the new accountant should request the right to consult with the present accountant and if he is refused should submit no fee estimate. The client is probably interested in using your bid only to reduce the fee he is currently paying. In the final case, the best practice is not to offer employment unless you first contact his employer or unless he has resigned.

This is an excellent article that is concerned with the philosophy of ethics rather than with the technical rules. The rules of professional conduct are fine basic principles but they establish a minimum standard. An admirable statement of the accountant's broad responsibilities is set forth by the author:

"The rules of professional conduct, like most rules, are basically negative. Thou shalt not split fees with the laity. Thou shalt not withhold a material fact in a financial statement. Thou shalt not advertise. The philosophical concept of ethics is positive, not negative. It thinks about ways of improving the profession and extending its members' services to the community."

A Punched Card Tabulating Service

For Medium and Small Businesses

PAYROLL • SALES ANALYSIS • INVENTORY CONTROL
ROYALTIES • COMMISSIONS • BILLING
STATISTICS

High Speed Machine Accounting

Fast Service • Accurate • Economical

ELECTRONIC BUSINESS SERVICES

1239 BROADWAY, NEW YORK 1, N. Y.

OREGON 9-1875

"THING" INSURANCE— *Ridiculous? —No!*



THINGS wear out. — How better can your clients anticipate replacement than by SAVING where CORPORATE SAVINGS ACCOUNTS are WELCOME? And if regular additions are made to an account over a period of years without withdrawal NINTH FEDERAL pays up to 1% extra.

Ask for Plus Value Folder CP-4.

ACCOUNTS INSURED TO \$10,000 • RESOURCES OVER \$83,000,000

NINTH FEDERAL SAVINGS AND LOAN ASSOCIATION



TIMES SQUARE: 1457 Broadway UNITED NATIONS PLAZA at 45th St. BURNSIDE at Walton Ave., BRONX
Hours: 9 to 3; Friday, 9 to 6 Hours: 9 to 3; Wednesday, 9 to 7 Hours: 9 to 3; Monday, 9 to 6

WISCONSIN 7-9119

WELLINGTON 3-3024

3%
Per Year

Funds received by
the 10th of the
month earn 3% divi-
dends from the 1st.

When writing to advertiser kindly mention The New York Certified Public Accountant

225

When Your Client Needs

FINANCING

... Call Us!

ACCOUNTS RECEIVABLE LOANS

LOW COST

NON-NOTIFICATION

CONFIDENTIAL

... BR 9-4167-8-9-70

HARRIS

**FACTORS
CORP.**

29 W. 34th St., New York 1, N. Y.

New! HI-FI

TRANSLUCENT

TAX FORMS

PRINTED BY

TRANSFACE

ORIGINATORS

of Two-Sided Printed translucent masters

HEADQUARTERS for:

TAX FORMS

ANALYSIS PADS

With reproducible or non-reproducible rules

CUSTOM DESIGNED FORMS

For every accounting and office system

Write for FREE SAMPLES & QUOTATIONS

TRANSFACE PROCESS COMPANY

170 Varick Street, New York 13, N. Y.

Telephone: WAtkins 4-5985

Sharing Fees with Other Professions

In an article on "Division of Fees" in the *Journal of Accountancy* (January, 1957), Mr. Thomas Higgins raises the question as to whether CPAs can divide their fees with non-CPA professional men. Rule 3 of the Rules of Professional Conduct prohibit fee-splitting with the "laity", but the American Institute has never defined this term. The author offers his opinion that this term includes non-accountants who are not members of any recognized profession, but probably does not apply to such professional men as lawyers and engineers.

Evaluating Internal Control

Some interesting comments on methods of internal control review may be found in "Evaluation of Internal Control" by a British accountant, E. D. McMillan, in the December, 1956 issue of *The Internal Auditor*. In describing how auditors should find out essential facts about the internal control system preparatory to evaluating it, the author warns: "It should be borne in mind that it is not always sufficient for an auditor merely to make inquiries and base his evaluation on what he is told; he should take whatever steps are reasonable to verify it."

The use of a questionnaire as an aid in obtaining the necessary information is commented upon particularly, because this does not appear to be a usual review method in England. In this regard, the author makes this dry but useful observation:

"I understand that the questionnaire is sometimes handed to the chief accounting officer with a request that he will supply the answers, but I hardly think that this procedure can be popular with chief accountants. In any case, I think the answers should properly be obtained from the people who are responsible for the detail work and are probably in a better position than the chief accountant to know the procedures actually carried out."

Operations Research

Two articles with similar titles set forth the accountant's role in the somewhat esoteric field of operations research. One is by Michael Schiff (*The Controller*, November 1956) and the other by Bernard Whitney (*Journal of Machine Accounting*, December 1956). Before showing how the accountant can participate, both authors describe operations research and point out that it is a new approach to an old problem.

tions

s" in the
(1957), Mr.
on as to
with non-
the Rules
e-splitting
Institute
hor offers
s non-ac-
any recog-
not apply
and engi-

methods of
found in
a British
December,
r. In de-
but essen-
ol system
e author
mind that
a auditor
is evalua-
ake what-
it."

n aid in
is com-
this does
method in
or makes

naire is
accounting
supply the
this pro-
account-
ers should
ople who
and are
the chief
actually

set forth
what es-
One is by
November
Whitney
December
accountant
be opera-
is a new

April

"It is the method of any experimental science. The OR (Operations Research) man studies business operations scientifically, looks for standard patterns and finds optimum solutions. His main tool is a scientific attitude; a power to analyze, to disregard the historic reasons for management action and approach the problem afresh." (Whitney)

Mr. Schiff puts it in a slightly different manner. "The new feature of Operations Research is the recognition that stable patterns underlie business operations as they do natural phenomena and the methods of experimental science applied to the study of business operations could expose these patterns to permit more effective management."

Applying this approach to accounting techniques, an accountant would adopt a particular method because it is simplest rather than customary. Some specific techniques are suggested. The first is the deletion of cents from accounting records. Another is the elimination of duplication in smaller companies by using copies of original data instead of a journal. Some examples are: duplicate checks to make up the check record, and duplicate sales invoices to replace the sales record and accounts receivable ledger. The replacement of three columns plus description in the general ledger with separate spread sheets for current assets, fixed assets, etc., is another possibility. The use of scientific spot checks made in accordance with the methods of sequential analysis to replace much of the detailed checking is cited as the final instance of the application of operations research.

Of particular interest to the CPA is this comment by Mr. Whitney on the value of a knowledge of operations research to the practitioner:

"Here is a new field not already taken over by another profession. The shortage and the demand are great. Any accountant with a liking for mathematics, a scientific outlook, or an engineering background should investigate this field. Especially the smaller firms who cannot employ many specialists will generally look to the CPA for help with their decision making."

Before rushing into this apparently green field, the CPA might pause to consider this somewhat terrifying listing of Mr. Schiff.

"Linear programming, queuing theory, decision theory, probability theory, game theory, cybernetics, search theory are but a few of [the new techniques] one encounters and all are grounded in advanced mathematical and statistical theory."

Directed by a C.P.A.

The Accountants & Auditors Agency

15 East 40th Street
New York 17, N. Y.
MUrray Hill 3-0290

*The
Employment Agency
Exclusively for
Accounting
Personnel*

Certified Public Accountants
Senior Accountants
Junior Accountants
Supervising Seniors
Cost Accountants
Internal Auditors
Payroll Auditors
Accounting Clerks
Tax Accountants
Budget Directors
Field Auditors
Systems Men
Controllers
Treasurers

1957

When writing to advertiser kindly mention **The New York Certified Public Accountant**

227

Letters to the Editor

Shakespeare and CPA Practice

Wasn't it Will Shakespeare?

"O, Be some other name! What's in a name? That which we call a rose
By any other name would smell as sweet!"

Congratulations and good luck on the semantics of the new title (Administration of a CPA Practice) in *The New York Certified Public Accountant*.

(MRS.) LOCKE GRAYSON
New York, N. Y.

Disclosure of Financial Interest in an Enterprise

Members of our Society have at times been approached by clients requesting a temporary loan, the endorsement of a note or an investment in the client's company. For the benefit of those members who would like to refuse these requests without antagonizing the client, I quote Rule 7 of the Society's Rules of Professional Conduct:

"A member shall not express his opinion on financial statements of an enterprise financed in whole or in part by a public distribution of securities, or on financial statements for use as a basis of credit, if he, a partner in his firm, or a member of his immediate family owns or is committed to acquire a *substantial interest* in the enterprise, or if he or a partner in his firm is an employee or director of the enterprise, unless he discloses such interest, employment or directorship in his report." [Italics supplied]

This rule is more lenient than the SEC regulations, which require that the accountant have *no financial interest* in the client. The Illinois CPA Society has also adopted the *no interest* rule.

Since the CPA does not always know at the time he renders an opinion on financial statements whether or not they will be used as a basis for credit, and since it is sometimes difficult to determine what amount of obliga-

tion or investment may later be deemed to be *substantial*, I would suggest that the CPA disclose in all cases, where he or his firm has *any* financial interest in the client.

The disclosure may be by means of a paragraph in the accountant's report immediately preceding or following the "opinion" paragraph or (where no separate report is rendered) by means of a balance sheet footnote. A simple statement that the CPA, a partner or the CPA firm, owns X% of the company, or has loaned \$X to the company, would suffice.

STEPHEN CHAN, CPA
New York, N. Y.

Interchange of Knowledge Among CPAs

I note with interest and approval the fact (reported by Max Block in his Department, *Administration of a CPA Practice*, in the January 1957 issue of *The New York Certified Public Accountant*) that Charles S. Rockey & Co. has made available for other practitioners a copy of the office manual used by the firm. I believe this willingness to share one's accomplishments with other practitioners contributes substantially to elevating the level of professional practice. I feel that Mr. Rockey's firm should be commended for this action.

The free and uninhibited interchange of knowledge among professional men is one of the basic requirements which must be fully met before our profession can hope to achieve the full status which I am convinced will one day be its due, not only in the eyes of the public but equally important in the eyes of all of the members of the profession.

TED ABRAMSON, CPA
Saint Paul, Minnesota

Need for Closer CPA - Banker Relationship

I read with a great deal of interest the article by Garrett T. Burns in the January 1957 issue of *The New York Certified Public Accountant*, entitled "How Can Bankers Obtain Information About CPAs". Mr. Burns

Advertisement

Under Today's Tight Money Conditions, many businessmen and their accountants are finding that their normal sources of capital can no longer supply them to the extent they require. For this reason they are turning to **factoring** as a dependable source of funds as needed.

Providing a business with the money it needs, as required, is but one of the functions of **modern factoring** — a specialized form of commercial financing. We believe you will be interested in reading two brief brochures which describe in detail how modern factoring is solving **many** of the credit and financial problems created by today's competitive conditions. The first of these brochures, entitled "**How to Meet Today's New Financial Requirements Through Modern Factoring**," is one of the most comprehensive analyses ever published on the subject. The second brochure, designed for distribution to your clients, discusses factoring in non-technical language. Its title is "**The Protected Profit Program**."

Both of these publications are available without cost or obligation to members of the accounting profession. Please write or call Mr. Walter Kelly, President, Commercial Factors Corporation, Two Park Avenue, New York 16, N.Y. MU 3-1200, specifying the publications and quantities required.

ACCOUNTS RECEIVABLE FINANCING

We will provide a revolving financing plan for your clients on a low-rate, non-notification basis.

Call today—we'll meet with you and your Client and work out a plan to meet their individual requirements.

PRUDENTIAL CAPITAL CORP.

527 FIFTH AVENUE, NEW YORK 17, N. Y.
MURRAY HILL 7-7680

EXECUTIVES

Morris P. Arnoff
Leo R. Heyman
Theodore Goldman

*Member of Association of Commercial
Finance Companies, Inc.*

BLADES & MACAULAY INSURANCE ADVISERS



*Complete Surveys of
Corporate Insurance Affairs
No Insurance Sold*

744 BROAD ST. NEWARK 2, N. J.
Established 1926

Robert Half
PERSONNEL AGENCIES
130 West 42 Street, N. Y. C.
LOngacre 4-3834
• branch office
• 25-15 Queens Plaza
Directed by a Certified Public Accountant

poses an interesting problem which has been of deep concern to the CPAs on Long Island for some time, but which we think we are solving through the activities of our Chapter Committee on Cooperation With Bankers.

Our chief problem in this part of the State, and I am sure it must be the same in all areas outside the larger cities, is the failure of bankers to differentiate between the CPA and the non-certified and accordingly, non-regulated practitioner. We all recognize that there are many capable accountants who are not CPAs, and that the good relations that they enjoy with the local bankers may be wholly justified and based upon professional performance at the highest level. We also know, however, that there are many bankers who accept at face value any statement prepared by one who calls himself a "public accountant", and who still are willing to blame the profession as a whole for the inadequacies of a few.

A short time ago, in addition to the above problem, there existed the widespread practice of accepting so-called "company statements" prepared by the borrower himself. This seems to have been corrected, at least as far as most Nassau County banks are concerned, and I think a great deal of credit for this is due to the work of the Society's and the Chapter's Committees on Public Relations and Cooperation with Bankers. We are sympathetic with the reasoning of the lending agencies in cases where the borrower is a long-time customer with a well established credit and personal relationship. We have even been told that the bank wishes to save the borrower the expense of an audit.

A number of certified public accountants are not good salesmen. Many are not able to sell the real value of their services and their profession to the banking fraternity. The day of the CPA who is only an auditor and perhaps a fair tax man is gone. The extensive public relations work of our Society will go for naught if it is not backed up by personal contact on the part of the members. The value of close relations with bankers lies not only in the advancement of the profession but also in the promotion of the CPA's own clientele. It would be interesting to conduct a survey among small practitioners as to the sources of new clients and to see the percentage that results from referrals by banks and other lending agencies. Such a survey might serve to awaken some members, who are not getting their share, to increase their efforts and support the Society's program in their behalf.

T. ROBERT SULLIVAN, CPA
Mineola, L. I.

So
first
our
talk
to b
nam
1.
tax
the
pass
Apri
2.
Fede
a di
diffe
Don
cows
hens
for
mix
then
Mea
our
day.
W
TI
neig
Vern
shre
eral
ahea
W
Ano

FIT
BOB
PHI

B

Co

MI

14

195

An Adirondack View

State Income Tax Returns during these first months of each year always seem to stir our (and your) ire and imagination. We are talking about personal returns. There seem to be two stirring rods that do this stirring—namely:

1. The final laws that develop each year's tax don't get passed until March or April the following year. In 1956 for 1955—passed April 7, signed April 6, returns due April 15th.

2. The State return is very similar to the Federal return. But a difference here, and a difference there; here a difference, there a difference, everywhere a difference—Old McDonald had a farm! We get all the pigs, cows, horses, chickens, tractors, and guinea hens sorted out and in their proper houses for the Federal tax return. Then we have to mix them all up in the barnyard again—and then put them into another system of houses. Meanwhile the taxpayers are looking down our necks and asking that it be done yesterday.

Well, boy, what would YOU DO?

That's easy. Take a tip from those shrewd neighbors across Lake Champlain — those Vermont Yankees, than which none are shrewder. Base the State tax on the Federal taxable income; and pass tax laws ahead instead of behind.

Well, cut another notch on the musket. Another problem has been solved.

LEONARD HOUGHTON, CPA
Saranac Lake Branch of
the "Adirondack Chapter"

APPRAISALS

NATIONAL ORGANIZATION OF
APPRAISAL ENGINEERS

STANDARD APPRAISAL COMPANY

PITTSBURGH 6 CHURCH STREET ATLANTA
BOSTON PHILADELPHIA NEW YORK, N. Y. CHICAGO
ST. LOUIS

BUSINESS LOANS

ACCOUNTS RECEIVABLE - -

MACHINERY MORTGAGES

NON-NOTIFICATION

CONFIDENTIAL

Consultation Without Obligation

Since 1940

MIDTOWN FACTORS CORP.

1441 BROADWAY N. Y. C.

CHickering 4-3073

NEED HELP?

"I can help you secure

Dependable

Hard-to-get

Personnel"



Wm. Schnuer, BBA, MBA
Licensee

**Our 18th year
catering to
Top-Notch
Executive
Personnel**

**Controllers
Office Managers
Accountants
Bookkeepers**

PROMPT SERVICE

Wm. Schnuer
Licensee

Shirley Schnuer
Licensee

Call
**BR 9-
7664**

Dependable

EMPLOYMENT AGENCY

220 W. 42nd St. • New York 36

Book Reviews

Professional Ethics of Certified Public Accountants

By John L. Carey. AMERICAN INSTITUTE OF ACCOUNTANTS, New York, N. Y., 1956. Pages: xiii+233; cloth, \$4.00; paper, \$3.00.

In this momentous project for the certified public accountants of America, John Carey has marshaled an army of ethical ideas and principles which can lead only to higher and higher levels of professional conduct and maturity. It is indeed "must" reading for certified public accountants who believe in the importance of the professional attitude in their careers and as a way of life. The book is a penetrating and knowledgeable treatise which accountants should read and re-read and keep on their desks for ready reference. It speaks of a fundamental philosophy for a modern profession. Its code of ethical conduct is demanding but an essential part of the discipline inherent in the truly professional outlook.

The accounting profession is growing dynamically in cultural meaning and in numbers. Extrapolation of the 1945-55 growth rate lends credence to the prediction of 70,000 CPAs in 1960 and over 100,000 by 1970. The author, in his intellectual approach to professional and ethical problems, displays extraordinary ability to adjust his thinking to this tremendous growth and the resulting increasing subtleties in the ever-changing framework of professional conduct.

The book is comprehensive and covers many complex professional situations. Its scope emphasizes how difficult it must be for the general public to understand the breadth and depth of the voluntarily assumed professional responsibility of certified public accountants.

In general terms, Mr. Carey in his book gives us: (a) a philosophy of behavior for the professional accountant; (b) the categorical imperatives of the professional code, as spelled out in the AIA's sixteen rules of conduct; (c) a rationalization of the moral values created by ethical conduct; (d) an evaluation of the impact of the professional attitude on public confidence, client rela-

tionships, and daily associations with fellow practitioners.

All through the book runs the implicit emphasis that a code of ethics is a practical working tool as necessary as theoretical principles and technical competence. The author distinguishes between a profession and a business and makes the point that the client, in retaining professional services, must rely on faith and cannot use the *caveat emptor* approach.

Again and again the author stresses the importance of professional competence, independence, and integrity as bulwarks of the certified public accountant's professional stature. On independence, he quotes the AIA Council--

"... Independence is an attitude of mind much deeper than the surface display of visible standards . . . Both historically and philosophically [it is] the foundation of the public accounting profession and upon its maintenance depends the profession's strength and its stature."

Mr. Carey's discussion of general ethical principles, their practical application to auditing, tax practice and management services, and his review of a certified public accountant's responsibilities to clients, associates, and the public welfare, show a fine sense of ethical discrimination, urbanity, and balance as he treads his prudent way among the pitfalls of unethical actions discreditable to the good name and reputation of the accounting profession.

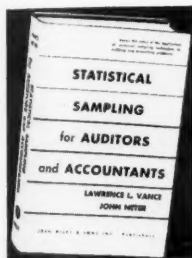
The book is divided in three major parts. One discusses the fundamental principles of professional ethics as they relate to the public interest, the professional attitude, and technical competence. Another analyzes and answers ethical questions which arise in the practitioner's daily work. The third section deals with relationships with clients, fellow practitioners, and the general public, and outlines ethical responsibilities to them.

The author constantly stresses that rules of professional conduct are not just "theorizing" or "romancing" but hard, down-to-earth principles which must be followed if a group activity is to be dignified by the name "profession". That his point is well taken is

*A brand-new
professional tool . . .*

STATISTICAL SAMPLING for AUDITORS and ACCOUNTANTS

By LAWRENCE L. VANCE,
University of California
and JOHN NETER,
University of Minnesota



Let this new book show you how to handle your sampling problems more objectively and efficiently! It introduces basic statistical sampling concepts and describes useful techniques, with illustrations wherever possible. It points out the nature of the auditing or accounting problem to be solved before the techniques can be effectively applied. Some of the questions it answers:

- How big a sample to take.
- How to select a sample.
- How to interpret the sample after it is examined.
- How to improve control of the quality of clerical work.
- How to substitute sampling for complete counting of such things as inventory, with the degree of precision specified.

Clear and practical in treatment, this is the first book to expound statistical methods for accounting (as distinct from auditing). One of the Wiley Publications in Accounting, Hiram T. Scovill and C. A. Moyer, editors. 1956. 310 pages, \$9.00.

Order your *on-approval* copy today! Mail this coupon

JOHN WILEY & SONS, Inc.
440 Fourth Ave., New York 16, N. Y.

NCP-49

Please send me **STATISTICAL SAMPLING FOR AUDITORS AND ACCOUNTANTS** to read and examine **ON APPROVAL**. In 10 days I will return the book and owe nothing, or I will remit \$9.00, plus postage.

Name.....

Address.....

City.....Zone.....State.....

☐ **SAVE POSTAGE!** Check here if you **ENCLOSE** payment, in which case we pay postage. Same return privilege, of course.

Accountants Professional LIABILITY INSURANCE

- **"No accountant in public practice can afford to be without Accountants Liability Insurance".**

—Chairman of A.I.A. Committee on Accountants Liability

* * * * *

- Send for new brochure describing recent coverage improvements in special policy available to members of N. Y. State Society of Certified Public Accountants.

HERBERT L. JAMISON & CO.

270 MADISON AVENUE, NEW YORK 16 • MURRAY HILL 9-1104

supported by the details of the individual rules themselves. In the area of independence, for example, the rules preclude the CPA from expressing an opinion on the financial statements of enterprises whose stock is publicly held, if he has a substantial financial interest in such enterprise. In the case of non-publicly held companies, the fact of the substantial interest must be disclosed in reports used for credit purposes. Contingent fees (except in tax cases) are forbidden, and concurrent service as independent auditor and director of a company is frowned upon. Commissions and fee-splitting are not acceptable.

In the field of general public interest, the accounting profession prohibits advertising and solicitation and discourages competitive bidding. Misleading professional designations are not allowed, and a member is not permitted to lend his name to the work of another who is not in partnership with him or in his employ. In the certification of financial statements, all material facts must be disclosed, and any departures from accepted accounting principles or material omissions of generally accepted auditing procedures must be clearly noted. Professional practitioners cannot practice under a corporate name.

In CPAs' dealings with their clients, Mr. Carey stresses the confidential relationship which exists and the prohibitions against the disclosure of information acquired by virtue of client relationships, except as required by the law. The exploitation of clients by accepting fees or other compensation from vendors recommended by the certified public accountant is taboo.

The book stresses the importance of the professional attitude in relations with fellow practitioners, pointing out that solicitation of clients of fellow practitioners is forbidden, as is the initiation of offers of employment to an associate's staff.

As one reads through this excellent presentation, he becomes conscious of the careful, thoughtful approach, the detailed analysis, the copious documentation, and the superior ability of the author to weave all the factual ingredients into a central theme — a theme or concept which provides a sound bedrock for practitioners to use as a reference point for their daily actions. Its readable interpretations of complex concepts and rules make it a working tool which should take its place on the accountant's desk along with his other essential reference material on auditing and accounting methods.

In reaching for the intellectual impact of this work, it becomes clear that here is a successful effort to high-light mores which distinguish professional conduct from laissez-faire behavior and which give us a basic code of conduct representative of the truly professional accountant.

The author, in his prefatory comment, says it may be too much to hope that anyone will read this book in its entirety. Those who have the sound growth of the accounting profession deeply at heart will feel he errs through modesty.

Mr. Carey's book is an outstanding contribution to the ethical development of the accounting profession and should be top priority reading for all its members.

H. P. C. Howe

New York, N. Y.

The Tax on Accumulated Earnings

By Robert S. Holzman. THE RONALD PRESS COMPANY, New York, N. Y., 1956. Pages: vii + 136; \$10.00.

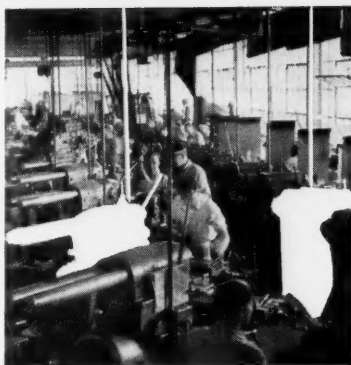
Although many stockholders and company executives have heard about the Federal tax penalty which may result from the failure to pay sufficient dividends, there is need for a fuller understanding of the nature of the penalty which might be imposed and of the conditions under which it might possibly be avoided. Misunderstanding, or lack of adequate knowledge in this area, may cause either overpayment or underpayment of dividends. Both courses of action can be needlessly expensive taxwise, and may be avoided only by a proper understanding of the nature of the accumulated earnings tax. Therefore, the company's certified public accountant should do his utmost to advise his client as to the amount of dividends which would reasonably appear to be payable in order to avoid either extreme. The danger is a real one, for despite changes brought about by the 1954 Code, the accumulated earnings tax continues to be a potential trouble area in any situation where earnings are retained by a closely-held corporation.

The book, *The Tax on Accumulated Earnings*, written by Dr. Robert S. Holzman, Professor of Taxation at the N. Y. U. Graduate School of Business Administration, brings together a thorough and complete analysis of cases dealing with the accumulated earnings

tax. This tax, now imposed by Section 531 of the 1954 Code, is more familiar to most of us as the Section 102 tax formerly imposed, under the 1939 Code, on the improper accumulation of surplus. Despite the change in name, the present tax is imposed on substantially the same type of surplus accumulation, so that a study of the various issues which have arisen in the past in this area can be most helpful. This book provides a convenient reference to such issues and should therefore be particularly helpful to certified public accountants as well as to stockholders and corporate officers confronted with the problem of determining the proper amount of dividends to be paid each year.

Perhaps the greatest value of this book to the corporate executive and his advisors is that it points out the potential dangers inherent in the accumulation of earnings, and, in addition, highlights the fact that what might seem to certain officers and stockholders to be valid business reasons for retention of earnings, may not be arguments which will be considered adequate to justify such retention for Federal income tax purposes. Having been made aware of the problem which may exist, those concerned will then be in a position to make careful plans to avoid, if possible, the imposition of the accumulated earnings tax. In this connection, some of the suggestions discussed in the fourth chapter of the book may be helpful. For example, this chapter contains a discussion of the importance of the determination of accumulated earnings on a tax basis rather than on the accounting basis as reflected on the books of the corporation (particularly in view of the \$60,000 exemption provided in the 1954 Code), as well as a consideration of the significance of a written record to show why earnings were retained, together with other similar practical matters.

The second and third chapters are of particular value to those using this book as the starting point for further study of the question of adequacy of a dividend payment. The second chapter consists entirely of a tabular classification of the reasons which have been advanced to justify the retention of earnings, together with a brief summary indicating the disposition made with respect to that issue in each case. The issues are classified broadly as to their general nature. For example, two such classifications are a fear of depression and expansion plans. This chapter is most useful in indicating briefly the treatment given to a particular argument, thus permitting a fairly rapid review of the issues which have arisen in the past. Chapter three consists



American Appraisals eliminate "Ghosts" in property accounts

An American Appraisal original cost study and check of physical assets often reveal items of property disposed of, but not eliminated from property records — affecting costs, profits and taxes.

The AMERICAN APPRAISAL Company

leader in property valuation
HOME OFFICE: MILWAUKEE 1, WIS.

Cagen
Personnel
Agency

Accountants
Controllers
Office Managers
Bookkeepers

509 Fifth Avenue
New York 17, N. Y.
Murray Hill 7-3250

When you think of Financing-

Accounts Financed Machinery Loans
Inventory Advances Orders Financed

Get in Touch With

MAJESTIC *Factors* CORP.

175 Fifth Avenue at 23rd Street
Flatiron Building New York
ORegon 4-1200

Recommended by Accountants, Banks,
Attorneys and Clients

Officers and Executives

JULIUS N. MESHBERG EDWARD W. GINSBURG
SIDNEY W. DORMAN SEYMOUR I. LEBOWITZ

Members of Association Commercial Finance Companies,
Inc. and New York Credit and Financial Management
Association.

Personalized CONTACT with Clients each month with the CLIENTS' SERVICE REPORT

To help you maintain contact with your clients, we will send you each month a real goodwill-builder, a bulletin containing current tax information. The Clients' Service Report is intended for the CPA who does not have the time for the necessary research to produce a monthly prestige-building tax letter. We do the spade-work, send you quality-printed, four-page bulletins which you mail to your clients. *The CSR is available only to CPAs.*

You will find in the bulletin authentic discussions of current tax problems, written in non-technical language. After years of publication the CSR is profitably used by hundreds of CPA firms throughout the country. The cost of the CSR is only \$15.00 per month plus 10¢ per copy. Subscriptions may be cancelled at any time. Sample copy on request.

Accountants' Publishing Co.
185 Devonshire Street Boston 10, Mass.

entirely of a grouping of past court cases by industry classification. This may be helpful in permitting a study of the extent to which reasons, which might appear adequate to justify the retention of earnings because of the peculiarities of the industry, have been accepted by the Courts in the past.

This book should be of value to all who read it to gain an initial understanding of the subject. Even those who have previously researched accumulated-earnings tax problems will find in the book helpful references to the various factors which have entered into determinations in this area in the past.

DON J. SUMMA

New York, N. Y.

Fiscal-Year Reporting for Corporate Income Tax, Technical Paper 11

By W. L. Crum. NATIONAL BUREAU OF
ECONOMIC RESEARCH, New York, N. Y.,
1956. Pages: 304-369; \$1.25.

This paper, excellent though it is, will not be of interest to the average accountant, nor was it intended to be. It is a scholarly work concerned with the effect of increased fiscal-year reporting on statistics of income, federal budgeting, problems based on describing or interpreting variations in national income, and appraisals of general economic conditions.

Although fiscal-year reporting existed in earlier years, its effect on analysis may have been negligible. However, while in 1928 about 12 per cent of corporate income tax returns were on a fiscal-year basis, by 1950 the number was almost 34 per cent and has become a factor which cannot safely be ignored.

Dr. Crum finds that although the shift may not have significantly affected the total figures, statistics of particular industries may be seriously affected by the shift and may no longer indicate a year centered at approximately July 1.

In analysing his problem, Dr. Crum has detailed the fiscal years used by various industries, and this information might well be of interest to the accountant concerned with the natural business year problem.

ALFRED M. SCHUYLER

New York, N. Y.

Classified Section

RATES: "Help Wanted" 20¢ a word minimum \$5.00. "Situations Wanted" 10¢ a word, minimum \$2.00. "Business Opportunities" 15¢ a word, minimum \$3.00. Box number, when used, is two words. Closing date, 10th of month preceding date of issue.

ADDRESS FOR REPLIES: Box number, The New York Certified Public Accountant, 677 Fifth Avenue, New York 22, N. Y.

HELP WANTED

Opportunity CPA, under 35 capable eventually taking full charge moderate Manhattan practice of CPA planning gradual retirement, please write fully. Box 1120.

BUSINESS OPPORTUNITIES

Mail and Telephone Service, desk provided for interviewing, \$6.50 per month, directory listing, Modern Business Service, 505 Fifth Avenue (42nd Street).

Justin Jacobs, investment information, DLgby 4-7140.

Statistical Typing, IBM typography, offset printing, Gitsham's, 480 Lexington Avenue, N. Y. 17, Plaza 5-6432.

CPAs, N. Y., N. J., Conn., W. Va., AIA, established over 20 years, heavy taxes, management (IE, MBA), substantial cash, seek practice, accounts. Box 1114.

CPA, with small clientele, good background and available cash wishes per diem work or full time management of larger practice leading to purchase of interest. Box 1115.

CPA, 13 years public accounting and tax experience, earning \$10,000., seeks association with overburdened or retiring practitioner or firm with potential growth to partnership status. Box 1116.

CPA, N. Y., gross about \$50,000., with midtown office desires association with smaller or similar practitioner, aim merging practices or joint administration and other mutual benefits. Box 1118.

CPA, young, substantial practice, good background, seeks association with overburdened practitioner or will merge with medium size CPA firm. Box 1119.

CPA, N. Y., N. J., AIA, heavy taxes, management (IE, MBA), substantial cash, seeks practice, accounts. Box 1121.

CPA, 31, 7½ years diversified public experience, Society member, capable, personable, desires association offering partnership with overburdened practitioner or one contemplating retirement, will relocate, capital available. Box 1122.

BUSINESS OPPORTUNITIES

Desk space in small private office, midtown, nicely furnished, telephone, office facilities, pleasant quiet environment, very low rental. CH 4-4744.

CPA desires office, preferably in midtown Manhattan. Box 1126.

Two Society members, require two offices in professional suite plus outside space for three legal files, stationery cabinet and typewriter desk for own part-time secretary (or secretarial services furnished), require telephone message service, air-conditioned or AC current, between 34th and 57th streets and 5th and 8th avenues. Box 1127.

Office space wanted with accountant, two private offices midtown, Fifth Avenue and East. Box 1128.

CPA, 35, with small practice, desires position or association offering partnership opportunity, 9 years diversified public experience, attorney. Box 1129.

SITUATIONS WANTED

CPA, age 40, 20 years public experience in all phases of accounting, with emphasis on institutions, nonprofits, fund raising, hospitals, investments, funds, real estate, seeking part-time or per diem work. Box 1123.

Assistant Controller, CPA, age 35, nine years recent supervisory and managerial experience in private and public accounting. Box 1117.

Immediately Available, accountants, office managers, bookkeepers, Bookkeepers & Accountants Division, Maxwell Employment Agency, 130 West 42 Street, N.Y.C., telephone LOngacre 4-1740.

CPA, Society member, 20 years diversified public experience, thoroughly experienced taxes, reviewing, audits, available per diem basis. Box 1124.

Assistant Comptroller, CPA, law degree, presently employed, seeks better opportunity, over 25 years diversified experience, public and private. Office management, financial statements, internal controls, credits and collections, taxes. Box 1125.

SEW UP A GOOD DEAL



for your firm . . .

The money you need, **when you need it**, can be available with no change in your normal business procedures. A revolving credit plan, through non-notification accounts receivable financing, with no maturities, is the answer.

This plan is different, since our customers receive their equities daily and pay only on the actual cash employed. Inquire now about this service.

the
MEADOW BROOK
national bank

WEST HEMPSTEAD OFFICE

MEMBER FEDERAL DEPOSIT INSURANCE CORPORATION

of the
years
many
you h
rewar
slow
the p
also,
unifor
broug
it will
the ne
in be
pillar
and te
your
that a
prolog
and th
welfar
commu
1957

The President's Page

Memories and Membership

It was a very real pleasure to me recently to write to members of the Society who had twenty-five, thirty, thirty-five, forty and forty-five years of membership to felicitate them on these milestones. There were many heart-warming responses and I am sharing some of them with you below:

"My entire adult life in the profession has been interesting and rewarding and I, too, look forward to the next quarter century (I hope)."

"From year to year the progress of the profession sometimes seems slow but when one is able, as you and I are, to look back over the decades, the progress seems remarkable. It is notable not only in numbers but also, I think, in education and quality of personnel, a greater degree of uniformity in standards, and in the increased prestige which these have brought with them."

"I think the progression is geometric rather than arithmetic and that it will continue this way. My only regret is that I cannot expect to see the next thirty-five years through."

"Membership in the Society to me was always a source of pride in being associated with a great organization and will always be a pillar of strength to me."

"As I write this letter, Mr. Foye, emotion has got the best of me and tears have welled in my eyes. I guess it's the honor of receiving your letter expressing the kind sentiments therein and the realization that a quarter of a century has passed by."

"... Indeed it is fitting, as you state, to regard the past as but a prologue and to look forward to continued growth in both the Society and the profession, not only to serve in the restricted area of our own welfare but in the larger sphere of our contribution to the future of our community and our country."

The President's Page

"In casting a brief glance backward over the years, my regret is that I have not been able to be more active in the affairs of the Society and to help in the progress, as those who, like yourself, have so devotedly and effectively done. May continued success reward your efforts."

"I have indeed witnessed the great growth of our profession and the Society, and the large influence it has had on the nation's economy. It has been a wonderful experience for me to have been in the center of these developments."

"It is hard for me to believe that I have been a member of such long standing. It seems like only a few years ago that I applied for membership and, as you so aptly point out, I have observed a tremendous growth in the Society during this period of time."

"I sincerely hope that I may continue to be a member of this worthwhile organization until my time of retirement, which is just a few years hence."

"Yes! the profession and the Society have grown tremendously since I became a member in 1912—there were only 324 on the Society's roster at that time, a rather small number compared to the present large membership of about 9,000—and it is with a somewhat nostalgic feeling that I recall those days when barely more than a handful of members attended the monthly meetings at the old Waldorf-Astoria in which the founders of the profession in this country participated. To the extent that I have contributed, in a modest way, to the profession's progress since I joined in its activities in 1912, I feel imbued with a high degree of satisfaction."

Sentiments such as these are the best evidence of the value of membership in the Society. It would be so well worth-while for every Certified Public Accountant in New York State to join. Perhaps you know of some who are not members. If so, please tell them what they are missing!

We are anxious to reach the nine thousand mark in membership by May 31, 1957 and are only 250 short. Your prompt effort at this time will bring us over our goal.

ARTHUR B. FOYE,
President

Should the Standards of Accreditation for the CPA Certificate Be Revised?

By ARTHUR B. FOYE, C.P.A.

The President of our Society offers an objective presentation and analysis of the major recommendations and issues reflected in the Report of the Commission on Standards of Education and Experience for Certified Public Accountants.

This morning Dr. Saxe and I intend to discuss the contents of the recent report issued by the Commission on Standards of Education and Experience for Certified Public Accountants. I shall briefly describe the background leading to the formation of the Commission and comment upon its recommendations. Dr. Saxe will also comment on them, bringing out the viewpoint of the dissenting Commission members.

Background of Accounting Education

The early development of the accounting profession in this country followed the pattern adopted in England, where apprenticeship was initially, and indeed

continues to be, the basis for entering the profession and granting the certificate. Virtually no formal academic training in accounting existed. The Wharton School of Finance and Commerce at the University of Pennsylvania was organized in 1881, with the inclusion of accounting courses in its curriculum. Growth was slow during the last decades of the nineteenth century. The passage of the first CPA law in 1896 in the State of New York was an epochal event. It was followed in 1900 by the establishment of the School of Commerce, Accounts, and Finance of New York University, and by many others in the ensuing decades. Other states followed with CPA laws, but there was little uniformity in either educational or experience requirements or in the examinations given under the various laws.

The American Institute of Accountants sponsored a uniform CPA examination and has finally succeeded in having it used in each of the states. This, together with the expanded university offerings in accounting—and there are more than 175 colleges and universities

ARTHUR B. FOYE, C.P.A., *President of our Society and a past President of the American Institute of Accountants, is a partner in the firm of Haskins & Sells, Certified Public Accountants.*

This article has been adapted by the author from his paper published in the PROCEEDINGS OF THE NEW YORK UNIVERSITY SCHOOL OF COMMERCE, SIXTH ALUMNI DEAN'S DAY HOMECOMING, DECEMBER 1, 1956.

Should the Standards of Accreditation for the CPA Certificate Be Revised?

having schools or divisions teaching accounting—brought the profession to the point where it could profitably re-examine its thinking regarding the most effective type of educational and qualifying experience requirements for prospective CPA's.

Formation of the Commission

In 1951 the New York Department of Education started a new study of the CPA law. In a meeting with representatives of accredited educational institutions and the State Board of Examiners (in which my colleague Dr. Saxe was a leading spirit), it was proposed that a broad study be made of the fundamental problems of preparing and qualifying individuals for the public accounting profession.

This was taken up on a national scale by the AIA, and in April 1952 a commission was appointed. It consisted of 24 accountants and educators (including Dr. Saxe and including Dr. Newsom in his then capacity of Associate Commissioner of Education of the New York State Department of Education). Members were selected for geographical representation and consisted of practitioners, state board members, accounting professors, and educational administrators. The work of the Commission was financed by the American Institute of Accountants, the American Accounting Association, state boards of CPA examiners and state societies of CPA's. The Commission's report was published in 1956 under the title of "Standards of Education and Experience for Certified Public Accountants."

The Long-Range Goals

The Commission's five basic recommendations for long-range goals for the preparation of individuals for entry into the profession as CPA's constituted the

most important part of the report. At the outset, I must state that although the recommendations of the majority of the members of the Commission are basically sound, and reflect the considered thinking of these practitioners and educators, due consideration must be given to the opinions of the dissenting members who are respected as outstanding leaders.

First, it is recommended that those who enter public accounting complete a program of study leading to a baccalaureate degree that includes a significant percentage of work in cultural and general subjects and adequate technical training. Accountants, I believe, would agree that the stature of the profession may be raised substantially by strengthening the educational requirements. In passing, it should be pointed out that the Commission's thinking in the first recommendation represents no basic change in the present requirements of our New York State Board of Certified Public Accountant Examiners.

Second, it is recommended that the candidate take a qualifying examination, presumably near the end of his four-year baccalaureate program. This examination would test the aptitudes and interests of those contemplating a career in public accounting. Unsatisfactory examination scores should serve as a deterrent to those who could neither profit by further training in accounting nor give reasonable promise of achieving a measure of success in the profession.

Third, a fifth year of professional academic training would be required. This would be a high-level professional educational program designed to equip the graduate to grasp the more advanced phases of professional accounting practice. It should be pointed out that this fifth year of training would be entirely

Should the Standards of Accreditation for the CPA Certificate Be Revised?

different from most curricula presently being offered and now considered a professional or graduate education.

Fourth, an internship program would be required when feasible for both the profession and the student. This would be a part of the formal five-year professional program. This suggested requirement, together with the testing program, should serve as a satisfactory advisory screening device for those who consider entering the profession.

Fifth, the Uniform CPA Examination would continue to be a requirement. We are extremely fortunate in that not only do all states and territories use the Uniform CPA Examination, but the majority make use of the grading service of the Board of Examiners of the Institute. Inasmuch as experience would not be required before taking the examination, it is the view of the Commission that the character of the latter would have to be modified. The examination, instead of being a measure of professional accounting competence, would be a test of the candidate's educational proficiency.

Meaning of the CPA Certificate

The dissenting members, whose competence and reputation I profoundly respect, recommend that the candidate complete his experience requirement before taking the examination and/or before the issuance of the certificate. The dissenting members express the opinion that the CPA designation serves as a badge of educational and professional qualifications and attainment. The majority of the Commission members feel that the CPA designation should serve to indicate that the candidate is competent to enter upon a career in public accounting.

Evaluation of Experience

This majority view as to the meaning

of the certificate is based in large measure on the belief that it is most difficult to evaluate the quality of a candidate's experience. The value of qualifying experience varies in accordance with the professional competency of the practitioner under whom the candidate serves and also the character of clients served. Of necessity, we must conclude that there are varying types of public accounting experience. Furthermore, there are many types of nonpublic accounting experience which might well be considered as at least partial qualifying experience for those who desire to sit for the examination. Except for the absence of our professional concept of independence, audit work performed by certain U. S. governmental agencies and by certain internal audit staffs of clients is a high-calibre experience and might well be considered in evaluating qualification for admission to the examination. Under the present requirements in many states, individuals who possess this type of nonpublic accounting experience and continue their employment in these areas are excluded from ever taking the examination and obtaining the certificate.

Effect on the Public Interest

The Commission's Report suggests that there is no real danger to the public in the fact that a number of professionally trained accountants may obtain the certificate although they are not seasoned practitioners. It is the feeling of the Commission that the vast majority of these individuals would take the wise course and obtain employment with seasoned practitioners, progress rapidly, and do credit to themselves, their employers, and to the profession. It would appear that a small percentage might brave a beginning professional career of their own. They would tend to perform professional work commensurate with their background and adequately serve

Should the Standards of Accreditation for the CPA Certificate Be Revised?

clients who have engagements of a certain level of difficulty. In other words, the engagement will seek the firm or the practitioner, rather than the latter seeking the former. This is the situation which prevails today.

Significance for New York State

We in New York often lose sight of the fact that we have been fortunate to have had strong professional accounting educational programs in our universities since the early history of the profession in this country. Many other sections of the country have not been so fortunate and are not so fortunate today. We have also had effective statutes and requirements which have maintained high standards of admission for those who desire to sit for the examination and

obtain the certificate. It is most essential that we be willing to concur in and encourage the adoption of professional and educational requirements which will strengthen the profession in many other parts of the country where such strength is sorely needed.

The Ultimate Goal

In closing, it is my sincere feeling that our entire profession should give serious thought to the study and consideration of the recommendations of the Commission. Their recommendations are far-reaching, and, if adopted in the not too distant future, should firmly assure the business world and our profession that we are not only a profession in name, but most definitely one in fact.

Training and Proficiency of the Auditor

The process of attaining that proficiency, which has been likened to the process of erecting a building, begins with the laying of a strong substructure of adequate technical training to provide support for the superstructure of subsequent experience. Being a professional man, the auditor must undergo a training of proportions adequate to the requirements of being a professional man, which means that his training must be adequate in technical scope and must include also an adequate measure of general education.

In order to qualify himself to carry out his functions, the independent certified public accountant has completed a rigorous course of professional study and training as a background to the essential practical experience he must obtain, for it is only by study, training, and practical experience that the independent auditor acquires skill in accounting and related matters. In the ordinary course of his day-to-day practice, he encounters a wide range of judgment on the part of management, varying from true objective judgment to the occasional extreme of deliberate misstatement.

He is retained to examine and report upon the affairs of a concern because, through his training and experience, he has become not only skilled in accounting and auditing but has acquired the ability and habit of considering dispassionately and independently the facts recorded in books of account or otherwise disclosed by his examination and because, as a result, his opinion provides reasonable assurance that a fair and adequate presentation of pertinent information has been made in the financial statements.

*from GENERALLY ACCEPTED AUDITING STANDARDS,
the American Institute of Accountants, 1954.*

A Summary Appraisal of the Commission's Recommendations

By EMANUEL SAXE, C.P.A.

The Commission's Report contains statements of dissent by four CPAs of the highest competence and reputation. This is the first published article in which a dissenting Commission member expands upon his formal statement.

Early in August, 1956, the 24-man Commission on Standards of Education and Experience for Certified Public Accountants rendered its long-awaited Report.* After providing a comprehensive background for the evaluation of the current situation, the Commission proceeded to make specific recommendations regarding standards of edu-

cation and experience for CPAs, adequate to meet the prospective needs both of the public and of the profession and, also, reasonably possible of attainment in the foreseeable future. In addition, recognizing that these recommendations might require one or more decades for complete acceptance and implementation, the Commission provided another series of interim recommendations as a desirable standard during the transitional period.

EMANUEL SAXE, C.P.A., is Dean of the BERNARD M. BARUCH SCHOOL OF BUSINESS AND PUBLIC ADMINISTRATION, THE CITY COLLEGE OF NEW YORK. For over ten years, to October 1956, Dr. Saxe served our Society as Director of Technical Services and Research and as Managing Editor of THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT.

This article has been adapted by the author from an extemporaneous presentation at the Society's General Meeting of November 13, 1956 and at the December 1, 1956 N.Y.U. Dean's Day luncheon. It is reprinted, with permission, from PROCEEDINGS OF THE NEW YORK UNIVERSITY SCHOOL OF COMMERCE, SIXTH ALUMNI DEAN'S DAY HOMECOMING, DECEMBER 1, 1956.

I have been asked to comment upon both sets of recommendations, with particular emphasis upon the views expressed in my Statement of Dissent, appended to the Commission's Report (pages 143-144).

First of all, let me say that I endorse the transitional recommendations as they have been proposed. In effect, they are virtually the same as those which have existed for many years in New York, and I believe them to be both sound and reasonable. And although I would have preferred a three-

* *Standards of Education and Experience for CPAs*; University of Michigan, 1956; pages: xxiii + 151.

A Summary Appraisal of the Commission's Recommendations

year experience requirement, I accepted the two-year prescription in a spirit of compromise.

It is in the area of the Commission's basic recommendations as to long-range goals that I find myself in partial disagreement with the majority. I shall now discuss my views with respect to these recommendations.

College Graduation

The proposed *college graduation* requirement, leading to the baccalaureate degree with a major in accounting (or its equivalent, achieved by the successful completion of additional business and accounting courses subsequent to graduation from another course of study) presents no difficulty, since it is the same as the corresponding transitional requirement.

The Qualifying Examination

The *qualifying examination* requirement is acceptable primarily because it is recommended as a tool merely to assist educational institutions in the selection of candidates for the newly proposed professional program. However, it must be stressed that the colleges are not necessarily bound by the examination result in any particular case; it is only one factor for consideration in the total admissions process.

It is proposed to administer this examination after college graduation and before admission to the professional part of the educational program. It should be observed that while this timing is satisfactory from the screening viewpoint, it is much too late for proper guidance purposes, since the undergraduate accounting major will have already been completed by the candidate.

A Professional Academic Program

A *professional academic program* of 12 months' duration is the third long-range goal. In this connection, the Commission is not merely recommending additional undergraduate study or completion of existing master's degree programs. Rather it contemplates a new

" . . . professional program, with classroom materials drawn from public practice, with faculties experienced in public accountancy and maintaining close contact with changes in that profession, and with students directly and specifically interested in preparing for a career in public accountancy as a CPA." (*Report*, page 130.)

This is a desirable objective, which should enable prospective practitioners to absorb more rapidly and effectively the values inherent in their staff experiences. However, a note of warning should be sounded.

The whole-hearted and active cooperation of the public accounting profession will be continually required for the successful development of the materials and personnel for such a program. Unless this is forthcoming one might wonder how a sufficient amount of the necessary "classroom materials drawn from public practice" will be made regularly available to all the professional schools. At present there is an understandable reluctance on the part of many firms to share with others, including schools, any part of the limited amount of such instructional materials which they have developed at considerable expense for use in their own private training programs. Furthermore, it would be desirable to ascertain how many successful, experienced practitioners, who are also competent to teach, are prepared to make the financial sacrifice inherent in the transfer from professional to academic

A Summary Appraisal of the Commission's Recommendations

life, especially should it involve a move to a distant campus.

An Internship Program

The inclusion of an *internship program* of approximately three months' duration (during the period of December to April) is listed as the Commission's fourth long-range recommendation. However, closer examination of the text of the Report (pages 135-136) indicates that this is not actually the case, but that

"... under present conditions it is believed that the proposed internship program should be established on a voluntary basis. It is hoped that the development of the recommended professional academic program, and an increasing degree of cooperation between practicing members of the profession and educators would permit the recommended internship program ultimately to be established as a general requirement." (*Report*, page 135.) Indeed, "a number of adjustments or alternatives to this recommendation may be desirable." (*Report*, page 135, footnote 74.)

An internship program can be mandated only if each candidate is assured of an equal opportunity to serve as such. There is considerable doubt in my mind as to whether this is possible in the foreseeable future, particularly in view of (1) the large number of students graduated each year; (2) the scheduling difficulties encountered by schools operating on a semester (rather than a quarter) basis; (3) the high cost to the college of properly supervising such an internship program; and (4) the right presently (and necessarily) reserved by the cooperating firms to select the interns to be attached to their respective staffs.

Consequently, I would favor the alternative suggested in footnote 74 of the Report (page 135), whereby proper

accounting experience would be accepted in lieu of the internship requirement.

The Uniform CPA Examination

The *uniform CPA examination* would also be continued by the Commission as a long-range goal. I am in complete agreement with this recommendation.

However, in view of the additional recommendation that candidates be admitted to the CPA examination upon completion of the required educational preparation and, if successful, that they be awarded the certificate, the level of the CPA examination would undoubtedly have to be changed, as would the meaning ascribed to the CPA certificate.

I dissent from the second phase of this recommendation. Since I believe in the retention of the practical experience requirement (discussed below), I would postpone admission to the *Auditing* part (only) of the CPA examination until after this experience requirement had been completed by the candidate. I would then set the level of the Auditing examination sufficiently high to make it a valid qualitative measure of the candidate's experience in actual practice.

Elimination of Experience Requirement

The Commission (with five dissents) also made a negative recommendation by failing to include an *experience* requirement among its long-range goals. It anticipates

"... that in the foreseeable future individuals will be prepared for public accountancy through the formal educational process." (*Report*, page 123.)

It does not believe it likely that many individuals, possessed of CPA certifi-

A Summary Appraisal of the Commission's Recommendations

cates not dependent upon an experience requirement, would undertake to practice on their own account without first obtaining experience with an established firm; or that, consequently, this constitutes any real danger to the public. Further, its conclusion to eliminate the experience requirement stems in some measure from the difficulties encountered by state boards of examiners in properly evaluating this factor.

Meaning of the CPA Certificate

I must dissent vigorously from the non-inclusion of an experience requirement of at least two-years' duration.

Initially, I am unable to accept the majority's interpretation of the meaning of the CPA certificate. To do so would nullify the many years of arduous work spent by the profession in educating business men, government, and the general public to accept the CPA certificate as an evidence of superior technical skill and professional responsibility. Even the majority group agrees that

"... it is unrealistic to assume that an experienced CPA can ever be produced entirely through the academic route * * * [and that] there will always be a shakedown and seasoning period required, after he enters the practice of public accountancy, before he can be considered to be a seasoned and experienced practitioner." (*Report*, page 56.)

I concur in the views on the subject of the experience requirement so aptly expressed by Messrs. Seidman and Claire (*Statement of Dissent: Report*, page 144), as follows:

"Ours is a 'practicing' not an academic profession. The public looks upon the CPA certificate as a mark of competence in practice, not a license to learn how to practice. To the public, the CPA,

young or old, denotes finished goods, not raw materials.

"To substitute added schooling for experience is to make topsy-turvy of the wisdom of the past. Instead of recognizing experience as the best teacher, it regards a teacher as the best experience. It ignores the many shortcomings of the classroom that the Commission report so clearly describes (pages 76-77).

"We have a profound respect for schooling. We think extensive education is a prerequisite to modern practice. But no matter how closely classrooms may try to simulate reality, they do not and cannot reproduce genuine accounting life. For example, it is only in actual engagements that there is opportunity to observe, if not experience, the workings of time pressures, client pressures, and the many other forces that give trial and meaning to 'objectivity' and 'independence'—the mainstays of our profession."

The Commission itself recognizes that only actual experience can provide adequate and effective training in the following areas: (1) preparation of working papers; (2) programming an audit; (3) preparation of accounting reports and financial statements; and (4) human relations. (*Report*, pages 76-78). While it is true that a junior accountant cannot learn everything about these fields in his two-year period of required experience, he will at least become acquainted with their basic principles and be able to recognize the presence of important problems beyond his level of competence in situations under his examination.

There is one additional point: The *Report* notes that

"A substantial number of CPAs are engaged in activities other than that of public accountancy." (*Report*, page 11.) Indeed, "many candidates sit for the [CPA] examination in order to qualify for particular positions or in order to demonstrate their competence for promo-

A Summary Appraisal of the Commission's Recommendations

tion in areas of work entirely removed from public accountancy." (*Report*, page 109.)

This irrelevant use of the CPA examination and the CPA certificate will undoubtedly increase if the experience requirement is abolished. Indeed, if a sufficient number of persons not engaged or interested in the field of public accountancy were thus able to obtain CPA certificates, it might even create grave problems of professional interest and regulation.

The Need for Careful Study

In conclusion, may I join in the hope previously expressed by my colleague, Mr. Foye, that the Commission's Report, and the discussions based thereon, will receive the most careful study and the widest possible consideration by the entire accounting profession. In this fashion, we shall continue to move steadily forward towards the achievement of the finest professional standards and the highest public recognition and status.

Human Relations and the Accounting Profession

The ability to get along with people is a desirable trait in every field of endeavor. In public accounting it is a necessary qualification for success. The beginner's relationships with his seniors, other assistants, partners, supervisors, clients' personnel, etc. will be influenced to a great extent by his ability to get along with people.

The beginner must know how to be a follower at the start of his career—but must be ready to assume leadership at a later date. He must know how to function as part of a team on one engagement and, perhaps, as part of a new team on his next assignment. He must be able to adapt himself easily to new conditions.

That the accountant must know how to handle people as well as figures comes as a surprise to many graduates. A course that will stimulate him towards trying to understand himself and others seems desirable for everyone, especially for the man who aspires to success in a field in which the personal qualifications are valued so highly.

*from a paper by Samuel J. Duboff, appearing in
BETTER ACCOUNTING THROUGH PROFESSIONAL
DEVELOPMENT, the American Institute of Accountants, 1952.*

Tax Status of Partnerships

By HERMAN H. COHEN, C.P.A.

In certain situations and by following prescribed procedures partnerships may, by election be treated as individual proprietorships or taxed as corporations.

Partnerships under the 1954 Code remind one of the "To be or not to be" phrase. There is a double election for certain of these to "downgrade" themselves to a mere joint ownership, or to "upgrade" themselves to a corporation. All this can be done while continuing on an even commercial level as a bona fide partnership.

Before going into the elections and how they operate, it may be advisable to take a short look at what constitutes a partnership for tax purposes. Unfortunately, the 1954 Code in this area adds no additional enlightenment to that contained in the 1939 Code.

Definition of Partnership

One does not generally realize how difficult the tax definition of the term

partnership may be until the attempt is made to define it. Both the everyday meaning and the definitions under varying state laws may be misleading in determining the meaning of partnership for tax purposes. The statutory definition states that "a partnership includes a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not for income tax purposes, a corporation, trust or estate."¹ That, of course, doesn't mean much more than if it said "if two or more partners get together to do business, the result is a partnership."

A somewhat clearer meaning of the term *partnership* has evolved from court decisions and Treasury rulings. Both sources together provide a guide that can most often be followed in determining partnership status. One court has defined a partnership as an association of two or more persons to carry on a business for profit. The courts generally require that the parties shall have joined together with the intent and for the purpose of carrying on a trade or business for their common benefit, each contributing property or services and sharing of the profits.² The

HERMAN H. COHEN, C.P.A. and member of the New York Bar, is a member of our Society and its Committee on Federal Taxation. Mr. Cohen is the author of several books on Federal Taxation and is a partner in the firm of Cohen & Feld, Certified Public Accountants. This article has been adapted from a paper presented by the author at a technical meeting of the Society held on October 18, 1956 under the auspices of the Committee on Federal Taxation.

partn
ten o
impli
A fo
a re
must
bear
where
partn
recogn
For c
recogn
band
corpo
ship,⁶
for in

Partne

An
a part
ited o
the m
arate
tax co
ceived
Under
partne
memb
Under
Comm
tention
tion, r
is not
taxabl
there
bers o
not to
cannot
situati
prefer
but th
able as
will b
facts p
conside
corpor

Tax Status of Partnerships

partnership can arise from either written or oral agreement or may even be implied from conduct of the members.³ A formal partnership certificate is not a requisite.⁴ Although all partners must share in profits, not all have to bear a portion of the losses. Even where a state law does not permit a partnership, a partnership may be still recognized for income tax purposes. For example, in states which do not recognize a partnership between husband and wife⁵ or do not recognize a corporation as a member of a partnership,⁶ there can still be a partnership for income tax purposes.

Partnership Regarded as Corporation

An organization which is defined as a partnership in the Code may, in limited circumstances, at the election of the members, be disregarded as a separate business organization, and the tax computed as if each member received his share of the income directly. Under other limited circumstances, a partnership may, at the election of its members, be taxable as a corporation. Under still other circumstances, the Commissioner, regardless of the contention of the members of the organization, may claim that the organization is not a partnership, but an association taxable as a corporation. Actually, there are situations in which the members of a partnership may want to elect not to be taxed as a partnership but cannot meet the requirements, and other situations in which they very much prefer to be taxed as a partnership, but the Commissioner holds them taxable as a corporation. While each case will be decided upon the particular facts present, the following factors are considered to be characteristic of a corporation:⁷

1. Continuity uninterrupted by death or transfer of beneficial interest.
2. Limited liability of owners.
3. Centralized management through designated representatives.
4. Title to property held by entity.

If the partnership has enough of these characteristics it may find itself taxed as a corporation rather than a partnership—at least when it serves the purposes of the Treasury. Even if characteristics exist which would normally produce a corporation label, the Treasury becomes extremely reluctant to permit taxation as a corporation where treatment as a corporation is insisted upon by the taxpayer. Thus the Treasury objected to taxing a partnership of doctors as a corporation where the result permitted the doctors to obtain the benefits of an approved employee benefit plan.⁸

Joint Ownership as Partnership

Various courts have held that the mere joint ownership of property, without the joint owners' intent to create a partnership, will not result in a partnership.⁹ This is so even though there may be some activity carried on by the owners directly or through an agent.¹⁰ The Treasury, however, in its new regulations, takes a much narrower view. It will only go so far as to admit that a joint undertaking merely to share expenses, or the mere co-ownership of property which is maintained, kept in repair, and rented or leased, does not constitute a partnership. But if any services are rendered together with such rental or leasing, even the minimum services usually rendered to a tenant, then a partnership results. Apparently, then, a net lease of property will not make joint owners partners; but if husband and wife own a two-family house as

Tax Status of Partnerships

tenants in common, occupy one half and rent the other half, supplying the usual service, they could, as a result, become partners.

Down-Grading A Partnership

Election to Down-Grade

Partnerships and other unincorporated organizations that would otherwise be taxable as partnerships may, in certain situations, specifically elect to be treated for tax purposes as a group of separate individuals rather than as a partnership. This election under no circumstances applies to a partnership which qualifies as an association taxable as a corporation. The election, in short, applies only in a situation where the organization would be taxable as a partnership, not where it would be taxable as a corporation. Also, when made, there may be an election to be completely excluded from application of the partnership provisions, or to be partially excluded. In either event, exclusion will be permitted only if the income of the individual members may be adequately determined without the necessity of computing partnership taxable income.¹¹

The exclusion in whole or in part is available in general only to two types of situations referred to in the Regulations as:

1. Investing partnerships.
2. Operating agreements.

Investing Partnerships

In order for the *investing partnership* to qualify, the participants must:

1. Own the property as co-owners.
2. Reserve the right separately to take or dispose of their shares of any property acquired or retained.
3. Not actively conduct business for joint profit or irrevocably authorize

some person or persons acting in a representative capacity to purchase, sell or exchange the investment property. However, each participant may delegate authority to purchase, sell, or exchange his share of any investment property for his account for a period of not more than a year.¹²

Strangely enough, this third requirement bars any election for persons jointly owning investment property even though this would appear to be precisely the situation to which the election would appear most applicable. The reason is that where a joint ownership is treated as a partnership, it is because the Treasury considers the joint ownership to be actively engaged in business. As such it doesn't qualify under condition 3, above.

Operating Agreements

Operating agreements refer to organizations formed for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted. This, of course, covers situations like joint interests in drilling for oil or mining for ores.

In order to qualify for exclusion under the operating agreements provision, the participants must:

1. Own the property as co-owners, either in fee or under a lease or other form of contract granting exclusive operating rights.
2. Reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used.
3. Not jointly sell services or the property produced or extracted. However, each participant may delegate

Tax Status of Partnerships

authority to sell his share of the property produced or extracted for his account for a period not to exceed the minimum needs of the industry, and in no event for more than one year.¹³

Election of Complete Exclusion

Election to have the application of the partnership provisions (Subchapter K) completely excluded apparently need not be made for the first year of existence and will apply only from the year of election. However, once made, the election is irrevocable so long as the qualifications remain or until the Commissioner approves discontinuance. Election may be made at the time of filing the return (plus extensions). Application to revoke must be made within 30 days after beginning of the year for which revocation is desired. The following are the requirements in connection with the election:

1. For the year of election the organization shall file with the District Director for the district in which it has its office or principal place of business, a duly executed partnership return which, however, shall contain only the name and address of the organization.
2. A statement shall be attached to the return, including:
 - a. The names and addresses of all the members.
 - b. A statement that the organization qualifies either as an investing partnership or under an operating agreement.
 - c. A statement that all of the members of the organization elect that it be excluded from all of Subchapter K.
 - d. A statement indicating where a copy of the organization's agree-

ment is available, or, if the agreement is oral, from whom the provisions may be obtained.¹⁴

The election for exclusion will be operative unless, within 90 days after the formation of the organization, any member of the organization notifies the Commissioner that he desires Subchapter K to apply and also advises the Commissioner that he has so notified all other members by registered or certified mail.

Once an organization has effectively elected to be completely excluded from the partnership provisions, it must file annually a Form 1096 for the organization and a Form 1099 for each person who was a member during any part of the calendar year. Under the caption, *By whom paid*, shall be shown the name and address of the organization. In lieu of *kind and amount of income paid*, shall be stated, *Filed under Section 761(a)* and the principal activity of the organization.

Election of Partial Exclusion

Any organization which qualifies for complete exclusion of partnership provisions, may apply for *partial* instead of complete exclusion. Partial exemption does not become effective until affirmative approval by the Commissioner, and, as with complete exclusion, the partial exclusion once granted is irrevocable unless the Commissioner approves the revocation.

Permission must be requested in writing not later than 90 days after the beginning of the first taxable year for which partial exclusion is desired. The request must set forth the sections of Subchapter K from which exclusion is sought; it shall state that the organiza-

Tax Status of Partnerships

tion qualifies either as an investing partnership or under an operating agreement, and that the members elect to be excluded to the extent indicated. Approval by the Commissioner will be subject to any conditions he may impose. In addition, annual partnership returns will be required containing such information as the Commissioner may request.¹⁵

Effect of Election on Partnership

As noted before, the election can be made after a partnership has been in existence for a period of years. Yet there is complete silence on the part of the Code or the Regulations as to the effect on the partnership and partners of making the election. It would seem that the election should constitute a liquidation of the partnership with a pro rata distribution of assets. However, with no such position taken by the Treasury, the partnership appears to vanish with no guide to the tax basis or tax consequences resulting from the disappearance.

Up-Grading A Partnership

Frequently, a group which has tried to organize and operate as a partnership has been held by the Commissioner to be an association taxable as a corporation regardless of the intent and wishes of the members. Under the 1954 Code it is possible, for the first time, for certain partnerships meeting specified requirements to elect to be taxed as corporations although for all other purposes they continue to be partnerships. Note that under these provisions the option or election lies exclusively with the partners, not with the Commissioner. Paradoxically, there are many instances where the group strenuously resists the efforts of the Commissioner to tax it as a corporation

and other instances where the group seeks affirmatively to comply with all the requirements to permit it to be taxed as a corporation. This may occur where taxability as a corporation is advantageous but other features of a true corporate existence are disadvantageous, or where local or state law does not permit incorporation of the particular enterprise.

Eligibility for Election

In order to qualify an unincorporated enterprise to elect taxation as a corporation, it is necessary that at all times, from the first day of the first year to which the election applies through the day of election, the enterprise be owned by not more than 50 individual members.¹⁶ If one partnership owns an interest in a partnership as to which an election is to be made, the individual members in both partnerships must be added in order to determine whether or not there are more than 50 members.¹⁷ The enterprise will also be disqualified from election if on any day during this same period any partner having more than a 10% interest, has more than a 10% interest in the profits or capital of any other unincorporated business taxed as a domestic corporation.¹⁸ This means that a sole proprietor who has elected to have his business taxed as a corporation cannot have more than a 10% interest in a partnership that wants to make the election. No partner may be a nonresident alien or a foreign partnership.¹⁹ In addition to these requirements there is one more that may prove to be the greatest stumbling block. The enterprise must be one in which capital is a material income-producing factor, or 50% or more of the gross income of the enterprise must consist of gains, profits or income derived from

Tax Status of Partnerships

trading as a principal or from buying and selling real property, stock, securities or commodities for the account of others (brokerage commissions).²⁰ For all practical purposes this makes it impossible for a professional partnership like an accounting or legal firm to qualify.

How the Election is Made

Many of the provisions under the "Election of a partnership to be taxed as a corporation" refer to regulations to be issued by the Commissioner. Since the regulations have not yet been issued, a certain area of doubt still remains as to what the final interpretations will be. Until now, the method of making the election is governed by temporary rules which have been issued by the Treasury.

The election must be made by a statement in writing, no later than 60 days after the end of the year to which the election is to apply, to the effect that the partners elect to have the enterprise treated as a domestic corporation under Section 1361(a). The statement is filed with the District Director in the same district in which the corporate return would be filed and must indicate that all qualifications for election have been met. The statement must also contain an agreement to notify the District Director if, at any time, the interests of the present partners become 80% or less or if the enterprise is incorporated. Signatures are required of every person who had an interest in the enterprise at any time during the period between the first day of the taxable year to which the election applies and the date of election. This applies even to a person who acquired his interest after the close of the taxable year but by the date of election.

The statement of election is only the first step of the process. The process

must be completed by the actual filing of a return on Form 1120 containing a statement that the return has been filed in compliance with regulations under Section 1361. Since the regulations have not yet been issued, there is a further provision that if the last day for filing the return is before the last day of the third month following the month in which the regulations appear in the *Federal Register*, then an amended return including a statement of compliance with the regulations shall be filed on or before the last day of the third month following the month in which the regulations appear. Each of the partners must also file an amended individual return or a statement that no such return is necessary.²¹

Irrevocability of Election

The election once made and perfected applies not only to the year of election but to each year thereafter, not only to the present enterprise but to each succeeding qualifying enterprise. Of course, dissolution or incorporation will terminate the effect of the election and, in addition, there is at least one event which will definitely revoke the election—the transfer of 20% or more of interests in the profits or the capital. But for the purpose of computing partnership interest, the constructive ownership rules of Section 267 (c) (1), (2), (4) and (5) apply, so that a transfer to a related taxpayer (as defined for this purpose) will be of no effect.²²

Once an election is terminated for any reason, the enterprise is again taxable as a partnership for the year of termination and for all succeeding years. However, a new election can be made at any time the partnership again qualifies by going through exactly the same procedure as initially. The election can again be made for the year in which

the first election terminated or for any subsequent year in which all the qualifications are met, but, during the years intervening between the termination of the first election and the effectuation of the second election, the enterprise will be taxed as a partnership.

Treatment of Partnership Taxed As a Corporation

An unincorporated business taxed as a corporation will be subject to the normal and surtax on income, the tax on unreasonable accumulations, and the alternative tax on capital gains.²³ It is not subject to the personal holding company tax. It will be taxed as a corporation with respect to its operations, distributions and sales of interests; but the enterprise is not treated as a corporation for certain reorganization and organization purposes, for self-employment taxes of members, and coverage of the members by an approved pension or profit-sharing plan. Evidently, for these purposes, the members of the enterprise are considered partners and not employees.²⁴

Calculation of Taxable Income

As yet there are no regulations to indicate clearly how taxable income is to be determined. However, the Code provides specifically that a reasonable amount may be allowed for salaries or compensation of partners for actual services rendered and for all other business expenses allocable to the operation of the business. Both personal holding company income and all expenses attributable to personal holding company income are eliminated in determining the net income of the enterprise. The intent is to allow the elective corporate treatment for income derived from business operations only. As defined here, personal holding company income in-

cludes dividends, interest, rents only if they amount to less than 50% of total gross income, and mineral, oil or gas royalties only if they amount to less than 50% of total gross income. It does not include income earned from the purchase and sale of real property, stock, securities, or commodities for the account of others. With these exceptions, personal holding company income has its usual statutory definition. Personal holding company income, less applicable expenses, is taxable directly to the partners who must pick up their respective shares in their personal income tax returns.²⁵

Distributions

Distributions in partial or complete liquidation will be treated no differently than such distributions by a corporation to a stockholder. There also seems to be an implication that non-liquidating distributions, other than current distributions of personal holding company income, will be taxed in the same way as corporate distributions.²⁶ But there appear to be many areas here that require clarification and the safest course would seem to be to await the regulations.

Conclusion

There are undoubtedly many situations where the right to elect taxation as a corporation will prove of great benefit. There are instances where corporate tax provisions are much more favorable than those applicable to partnerships and their partners but for some reason the partnership cannot incorporate or incorporation would have certain disadvantages. But before taking the final plunge into a corporate tax existence by election, the concomitant disadvantages should be studied.

Tax Status of Partnerships

The answers which the regulations may provide to many questions now unanswered may determine the advisability or inadvisability of choosing to be taxed as a corporation. Perhaps it would be better to suspend decision until "R" day.

References

1. Internal Revenue Code Section 761 (a).
2. *Meehan v. Valentine*, 145 U.S. 611.
3. I.T. 1418, CB 1-2, 2.
4. *Seattle Renton Lumber Co. v. U.S.*, 135 F(2d) 989.
5. *Anderson*, 6 T.C. 956; *Parker*, 6 T.C. 974.
6. *Frank Trust of 1927*, 44 B.T.A. 934 (NA) Remanded pursuant to Stipulation, (CCA-3) 1/8/43.
7. *Morrissey v. Com.*, 296 U.S. 344.
8. *Kintner v. U.S.*, 107 F. Supp. 976, Aff'd 216 F. (2d) 418.
9. *Coffin v. U.S.*, 120 F. Supp. 9.
10. *Gilford v. Com.*, 201 F (2d) 735.
11. Internal Revenue Code Section 761 (a).
12. Regulations 1.761-1(a) (2) (ii).
13. Regulations 1.761-1(a) (2) (iii).
14. Regulations 1.761-1(a) (2) (12) (a).
15. Regulations 1.761-1(a) (2) (12) (b).
16. Internal Revenue Code Section 1361 (b) (1).
17. Senate Report No. 1622, 83rd Cong., Second Sess., p. 456.
18. Internal Revenue Code Section 1361 (b) (2).
19. Internal Revenue Code Section 1361 (b) (3).
20. Internal Revenue Code Section 1361 (b) (4).
21. T.D. 6124, IRB 1955—10, 34.
22. Internal Revenue Code Section 1361 (1).
23. Internal Revenue Code Section 1361 (h).
24. Internal Revenue Code Section 1361 (d).
25. Internal Revenue Code Section 1361 (i).
26. Internal Revenue Code Section 1361 (1); Senate Report No. 1622 834d Cong., Second Sess., p. 457.

The Preparer's Declaration on Income Tax Returns

Some practitioners qualify the declarations as printed on the returns in order to indicate the extent to which the figures have not been verified. These qualifications are in some instances handwritten or typed on the return; in other instances inserted by rubber stamp. The words may vary, but the effect is to state that the figures were not audited or that they were furnished by the taxpayer without verification by the person who prepared the return.

There is a divergence of opinion among practitioners as to the wisdom of making a disclaimer on returns. It is difficult to see how the CPA assumes any risk in signing the declaration without qualification as the statement merely indicates that the return is based upon those facts of which the preparer has knowledge.

Due to the wide divergence of opinion on the subject of the importance or effect of disclaimers, it is not the purpose herein to decide this controversy.

Since the propriety or wisdom of making a disclaimer is debatable, the choice should be made by each practitioner. In any event, no return should be prepared by a CPA if he believes that the information at his disposal is not true, correct or complete. A disclaimer regardless of form should not be the means of justifying the preparation of a return which does not reveal a reasonably accurate picture.

*from the chapter on "Tax Practice" by I. H. Kreckstein,
THE CPA HANDBOOK, the American Institute of Accountants, 1956.*

Retirement or Death of a Partner

By ARTHUR J. DIXON, C.P.A.

An analysis of the problems arising from the liquidation, by cash distributions, of a retiring or deceased partner's interest, particularly in the light of the final partnership regulations.

When a partner retires or dies, he or his estate is usually paid out by the partnership in cash. The tax effects of this transaction, on the retiring partner or the estate and on the partnership, have been explicitly spelled out in the present law (but, as will be noted, with many complications). This article does not deal with the tax consequences of non-cash distributions.

Allocation of Cash Payments

The cash payments in liquidation of the partnership interest must be broken down among the following categories:¹

1. *Substantially appreciated inventory*, which includes inventory and all other non-capital assets (other than real or depreciable property used in the business) provided that the total fair market value of all such items exceeds 120% of their aggregate adjusted basis

and also exceeds 10% of the fair market value of all partnership property other than money.²

2. *Unrealized receivables*, which is defined as any right to payment for services rendered or to be rendered or goods delivered or to be delivered, not previously includible in income, under agreements in existence at the time of the liquidation payment.³ Examples of such receivables are accrued fees of a cash basis accountancy partnership, or unbilled work-in-process of an accrual basis firm.

3. Goodwill.

4. All other assets of the partnership.

5. Any other payments, such as the mutual retirement or mutual insurance arrangements which exist in many professional partnerships.

Method of Allocation

The actual allocation of the liquidation payments among the above groups as made by the partnership and the recipient in an arm's length agreement will generally be recognized.⁴ The conflict of interest between the payor and payee in making the allocation lends great weight to its reliability. If an allocation is not made by the parties, it then presumably becomes a valuation

ARTHUR J. DIXON, C.P.A. and member of the New York Bar, is a member of our Society and of its Committee on Federal Taxation. Mr. Dixon is a partner of the CPA firm of Oppenheim, Appel, Payson & Co. He is also a member of the Committee on Income of Estates and Trusts of the Tax Section of the American Bar Association.

Retirement or Death of a Partner

tion question to be determined by all the facts and circumstances.

After the portion of the liquidation payments attributable to each of the above categories has been determined, the tax consequences will vary with the category involved.

Substantially Appreciated Inventory

The partnership is treated as having purchased the retiring or decedent partner's interest in *substantially appreciated inventory*. The recipient realizes ordinary income measured by the difference between the outgoing partner's share of the partnership basis of the inventory and the amount received. The partnership, being treated as having purchased such items, gets a stepped up basis for computing its profit on subsequent sales.⁵ Note that, in the case of an estate of a deceased partner, its share of the partnership basis for the inventory items includes the adjustment permitted under Section 743 (if the proper election has been made under Section 754) which, in effect, measures the profit by the date of death value to the deceased partner rather than by the original cost to the partnership.⁶

Unrealized Receivables

Payments allocated to *unrealized receivables* are ordinary income to the recipient to the extent that they exceed his share of the partnership basis for the receivables. In the case of the estate of a deceased partner, the partnership basis includes the same type of Section 743 adjustment described above for substantially appreciated inventory.⁷ Therefore, the payment to the estate for the receivables to the extent of the date of death value is apparently treated as a capital distribution.⁸ Applying the regulations literally, the decedent's share of the value of untaxed partner-

ship accounts receivable would seem to escape "income in respect of a decedent" treatment. It is very doubtful, however, that this was the intention.⁹

To the extent that the retiring partner or the estate has ordinary income, the remaining partners have an ordinary deduction.¹⁰

Goodwill

Treatment of goodwill payments depends completely upon the partnership agreement. If the agreement does not provide for a goodwill payment, any amounts actually paid for such asset are ordinary income to the estate or retiring partner and an ordinary deduction to the partnership.¹¹ A provision in the agreement for a reasonable payment for goodwill, however, has the effect of adding such amount to the payment for other assets of the partnership which, as explained below, is a capital distribution to the recipient and a capital acquisition by the partnership. It is obvious that the decision as to which path to follow with respect to these payments is of great importance to all of the members of a partnership. This business decision should be made in advance of the event rather than after its occurrence when the partisan interests of the parties may cloud their better judgments.

Other Assets

As indicated above, payments attributable to the other firm assets are treated as a sale of a capital asset by the retiring partner or the estate. Capital gain or loss is measured by the difference between the cash received and the basis to the recipient of his partnership interest¹² (as reduced by the portion thereof allocated to the substantially appreciated inventory).¹³ The partnership is treated as having purchased the outgoing partner's capital interest.¹⁴

Retirement or Death of a Partner

If the amount paid to the outgoing partner represents appreciation in the value of the partnership assets, the partnership may, upon making the proper election, increase the tax basis thereof.¹⁵

Other Payments

Any additional sums paid by the partnership to the retiring partner or the estate of the deceased partner are treated as ordinary income and the partnership is entitled to an ordinary deduction. Payments actually attributable to goodwill, where the decision has been made not to provide for such payments in the partnership agreement, fall into this category.

Any payments resulting in ordinary income to a retiring partner or estate because of the application of the above rules (other than the profit on the sale of substantially appreciated inventory) are considered "guaranteed payments" if they are in a fixed dollar amount, or partnership distributions if they are measured by income.¹⁶

Liquidation Payments—Income and Capital Allocation

If the liquidation payments made by the partnership are spread over more than one taxable year and represent both income and capital distributions, allocation is made as follows:¹⁷

1. If the payments are installments of a fixed sum (i.e. "guaranteed payments"), they are allocated annually between income and capital in a proportion measured by the total income and capital distributions eventually payable.
2. If the payments are measured by partnership income, the first payments are considered the capital distributions, and only after the total capital distributions have been made is the balance considered income payments.
3. Despite (1) and (2), the partnership and the retiring partner or the estate

of the deceased partner may agree to any other allocation, provided that the amount attributed to capital may not exceed the fair market value of such assets at the date of death or retirement.

Normally, the capital distributions are first applied to the basis of the recipient's partnership interest, with a resulting capital gain only after the full basis has been recovered.¹⁸ If the payments fall into group (1) above (installments of a fixed sum), the retiring partner or the estate may elect to allocate the basis of the partnership interest proportionately over the capital distributions to be made, thus reporting the capital gain annually in much the same manner as an installment sale.¹⁹

Estate Basis and Income

It should be noted that all of the ordinary income payments outlined above (except, once again, the profit on substantially appreciated inventory) are "income in respect of a decedent" when received by the estate of a deceased partner.²⁰ In addition, the portion of the partnership income for the year of death attributable to the period before the partner's death, but reportable by the estate, is "income in respect of a decedent". This is so even though the decedent withdrew part of his pre-death partnership profits so that they are not definitely identifiable in his estate.²¹ In computing the estate's basis for its partnership interest, however, reduction must be made for the portion of the final year's profit which is treated as income in respect of the decedent.²² This is to prevent such items from being added twice because they are presumably included in the fair market value at the date of death, which is the starting point for the estate's basis computation,²³ and are added again as income taxed to the estate.²⁴

References

1. Regulations Sections 1.736-1(a)(2) and 1.751-1(b)(4)(ii). But note that these rules are not applicable in the case of a sale of the partnership interest, even if the sale be made to another member of the partnership. Regulations Section 1.736-1(a)(1)(i).
2. Section 751(d).
3. Section 751(c).
4. Regulations Sections 1.736-1(b)(1) and (3).
5. Regulations Sections 1.736-1(b)(4) and 1.751-1(b)(3).
6. Regulations Section 1.755-1(b)(2). The adjustment under section 743 referred to is an innovation in the 1954 Internal Revenue Code. When a partnership interest is transferred either by sale or upon death, the transferee's basis for his partnership interest may exceed the transferor's basis. Nevertheless, under prior law, this increase in basis was not reflected in the partnership's basis for its assets. The transferee might, therefore, pay tax on the realization by the partnership of appreciation already reflected in the basis of his partnership interest, with recoupment postponed until the liquidation of the partnership. The section 743 adjustment, in effect, increases the basis of partnership assets to reflect the appreciation, with such increase being solely for the benefit of the transferee.
7. Regulations Section 1.736-1(b)(2).
8. Regulations Section 1.736-1(b)(1).
9. Regulations Section 1.691(a)-1 provides that the term "income in respect of a decedent" includes "all accrued income of a decedent who reported his income by use of the cash receipts and disbursements method". It goes on to provide, however: "See sections 736 and 753 and the regulations thereunder for 'income in respect of a decedent' in the case of a deceased partner." Regulations Section 1.753-1(a) states that "all payments coming within the provisions of section 736(a) made by a partnership to the estate or other successor in interest of a deceased partner are considered income in respect of a decedent under section 691." But, as pointed out above, Regulations Section 1.736-1(b)(2) treats as payments under section 736(a) only the

amounts received "by the successor in interest of a deceased partner for his interest in unrealized receivables of the partnership in excess of their partnership basis, including any special basis adjustment for them." The example, however, in Regulations Section 1.753-1(c) indicates that payment for the unrealized receivables given in the illustration is "income in respect of a decedent" to the estate of the deceased partner, without referring in any way to the estate's possible special basis adjustment.

10. Regulations Section 1.736-1(a)(3).
11. Regulations Section 1.736-1(b)(3). The ordinary income treatment is limited, however, to the payments made for the outgoing partner's share of the "goodwill of the partnership in excess of its partnership basis, including any special basis adjustments for it to which such partner is entitled." A deceased partner's estate, when proper election has been made, may have a special basis adjustment for goodwill equal to its fair market value at date of death (see section 755 and the regulations thereunder and the prior discussion in this article of unrealized receivables and substantially appreciated inventory). Once again, a literal application of the regulations seems to negate the intent of the law.
12. Regulations Section 1.736-1(a)(2) and (b)(1); Section 731(a).
13. Regulations Section 1.751-1, Example (2)(d)(1) and (2).
14. Regulations Section 1.736-1(a)(2).
15. Section 734.
16. Regulations Section 1.736-1(a)(3).
17. Regulations Section 1.736-1(b)(5).
18. Section 731.
19. Regulations Section 1.736-1(b)(6).
20. Regulations Section 1.753-1(a). See, however, the discussion with respect to unrealized receivables at footnote 9. Note also that whenever reference is made in this article to the estate of a deceased partner, the same statements are applicable to any other successor to the partnership interest. Regulations Section 1.706-1(c)(3)(iii).
21. Regulations Section 1.753-1(b).
22. Regulations Section 1.742-1.
23. Regulations Section 1.742-1.
24. Regulations Section 1.705-1(a)(2)(i).

Problems of Perpetuating the Small Business Entity

By LLEWELLYN L. ROGERS, C.P.A.

When a business entity ceases to exist, severe economic loss is often suffered by the owner's family, the employees, and the community. In many cases, this loss can be avoided by careful advance planning.

When we speak of the "Small Business Entity" it must be kept in mind that we may be referring to either a sole proprietorship, a partnership, or a closely-held corporation. Each of these forms of doing business has its own peculiar problems in a legal sense, and it is not our purpose to attempt to define all of the legal aspects here. Nevertheless, we cannot intelligently discuss problems of perpetuation without at least some comment on the differences in structure between the three forms of doing business.

Legal Implications

The sole proprietor has perhaps the greater problem, if he wishes his business to survive him. Unless he has grown-up and mature children who are active in the business, or else key em-

ployees who are substantially younger than himself and who are firmly tied to the business, it is most probable that his business will die with him. That is to say, it must be sold or liquidated, either by himself during his lifetime, or by his Executor after his death.

The member of a partnership faces a somewhat similar problem, in that all partnerships are automatically dissolved by death of a partner. This does not mean, however, that the business ceases to exist, since the surviving partner or partners may be agreeable to re-forming a new partnership with his heirs or successors, or among themselves. In the partnership, management capable of carrying on the business is much more likely to exist.

The closely-held corporation, being an artificial entity, will legally survive its stockholders. This does not mean that it will necessarily continue as a going business, particularly where all of the stock is owned by one individual, or in cases where that individual is the majority stockholder and dominant personality in the business. It is true, however, that the problems of perpetuating

LLEWELLYN L. ROGERS, C.P.A., is President of the Binghamton Chapter of our Society. He is associated with Connecticut General Life Insurance Co. in the field of estate and business analytical service. Mr. Rogers has written extensively on the subject of Estate Planning.

Problems of Perpetuating the Small Business Entity

the closely-held corporation are somewhat more easily solved in the usual situation, due to the corporate structure.

Aside from the purely legal aspects of survival, many vital questions must be answered if a business is to survive its owner or owners. Indeed, it seems fair to say that the legal possibility of survival and perpetuation is the simplest problem which must be solved.

Two Vital Needs

No business can survive without capable, trained, and thoroughly experienced management. It must also have adequate working capital remaining in the business after the affairs of the former owner have been settled. *Dun and Bradstreet* tells us repeatedly that the major causes of business failure are inadequate working capital, and inexperience in the line of business. Supplying these two necessities is the major problem facing the business owner who wants his business perpetuated. Certainly certified public accountants are well aware of the necessity of advance planning to meet these two vital needs.

Sources of Successor Management

There are many sources of successor management. The owner may have one or more sons or daughters who are actively interested in his business, and who have the mental and physical capacity to follow in his footsteps. This is perhaps the most fertile field for successor management in the small business field, particularly if the children can be brought into the business while the father is still alive and active in the business. Key employees, partners, and stockholders also offer opportunities in providing for efficient management. Last, but by no means least, bringing in skilled successor management from outside sources may be the most practical

solution. Substantial numbers of trained executives are readily available in the "over 40" age group, and many of these men need little or no training period. Further, they may be well able to operate the business for twenty, twenty-five, or even more years, and they are less likely to be "shanghaied" by the larger firms in the area, or in the line.

Management Rewards

Many devices exist for tying successor management firmly to the business. Not the least of these is money. It is still as true as it ever was that men work primarily for financial reward. Adequate salaries, retirement plans, profit sharing, salary continuation plans, and many other methods may be effectively used. Another effective device is the partial or gradual turning over of ownership interest to paid management, in order that perpetuation of the business may become a personal as well as a financial goal for the successors. In the partnership and corporation, effective use may be made of cross purchase or "buy and sell" agreements to compensate the owner's estate, while at the same time enabling the surviving partners or stockholders to continue the business.

Adequate Working Capital

Hand in hand with successor management problems is the necessity for adequate working capital *remaining in the business after the former active owner dies or retires*. This is the number one problem facing most business owners when they decide that they want their business perpetuated. Many concerns are working with inadequate capital *while* the owner is still active. What will the business use for capital if every available dollar is drained off to pay the death taxes and other expenses of settling the former owner's estate? Or,

Problems of Perpetuating the Small Business Entity

where buy and sell agreements exist, what will the other partners, shareholders, key employees, or the corporation itself, use for working capital where all, or nearly all the liquid capital has been used to buy out the interest of the deceased or retiring owner?

As in the case of successor management, many devices exist for accumulating or acquiring the essential dollars to guarantee adequate working capital. However, before we can arrive at any solution, it is first necessary to clearly understand what we need cash for, and in what amounts.

In many cases (perhaps we should say in *most cases*), the business interest represents the largest single asset in the owner's estate. As such, its valuation for Estate Tax purposes will have a marked effect on the amount of cash required to settle his estate. That valuation figures may vary widely has been clearly demonstrated in a recent case where valuation varied from \$516 per share by the Executor to \$4,000 a share by the Commissioner of Internal Revenue. (*Estate of Eugene H. Kelly*; Memo TC 129; 1955.) Here, the final determination of the Court was that the value was \$2,200 per share. Remember, each "expert" in this case had the same facts available, yet only two of the nine different valuations arrived at were in agreement. Without an accurate valuation of the owner's interest, we can neither compute his estate tax position, nor determine what portion of his liquidity needs must be supplied from his business assets.

Liquidity Needs of Owner's Estate

It is essential that as accurate an estimate as possible of the total liquidity need of the owner's estate be arrived at. This estimate should cover not only

State and Federal death taxes, but also costs of administration, attorney fees, debts and obligations which must be paid, possible costs of appraisal and/or litigation, and other necessary expenses. These expenses in turn will depend on *all* of the property in the estate, including personal property, real estate, and life insurance, as well as the business interest. It is also vital that the underlying documents, such as wills, contracts and agreements by which the property will pass, be carefully examined, since they too will have a decided effect on costs.

Sources of Working Capital

After the probable liquidity needs of the business owner's estate have been determined, it is a fairly simple matter to suggest sources of cash with which they may be met. This would include life insurance proceeds, cash on hand, government bonds, and possibly cash derived from his business interests. If cash from the latter source is required (and it usually is), it is essential that the business entity be provided with a source of cash to meet these demands, without impairment of working capital. In this connection, it is necessary to determine as accurately as possible just what working capital must be retained in the business, if it is to continue to operate successfully. In many instances, it will be found most practical for the owner to cover the cash needs of his estate *and* his business through the use of life insurance, provided he is still insurable.

Having arrived at a reasonably accurate estimate of liquidity needs in the business, and in its owner's estate, the next question is how to fund those needs. The most obvious answer, life insurance, has already been mentioned. This is the only absolutely certain way

Problems of Perpetuating the Small Business Entity

in which cash in the right amount can be made available to the right parties at the right time. Other methods are often used, for a variety of reasons, and with equally varying success. These include funded reserves, borrowing, accumulation of earnings in the business, while in some instances, where a portion of the business is to be sold, reliance is placed on the buyer's capital.

All have their weaknesses. Funded reserves require time to accumulate, and are often diverted to other uses so that they are not available when the need arises. Borrowed capital involves interest expense, and ultimately the principal must be repaid. All of us know that somehow or other accumulations out of earnings just never seem to materialize. As for buyer's capital, it may not be available when the time comes, and furthermore, the potential buyer may not materialize.

Should the Business Be Perpetuated?

It might be well to point out that before any extensive work is undertaken to make perpetuation of the small business entity possible, certain tests should be applied to determine whether or not the entity is really worth perpetuating. If its success is almost totally dependent on the personal services of the principal owner, or if it is a highly personalized

business, it will be virtually impossible to perpetuate it, no matter how carefully we plan to provide substantial cash reserves and stable successor management. If it is a very speculative type of business, either because of market conditions in the locality, or because of the nature of the commodity handled, again it would appear unwise to attempt its continuation. Wisdom may indicate that the owner should plan for outright sale or liquidation when he reaches retirement age or when he dies. The facts of each individual case must be carefully weighed, and should be the deciding factor, rather than the mere fact that the owner wishes to perpetuate the business.

Conclusion

This article attempts to do little more than point out some of the problems to be faced in perpetuating the small business entity. If the decision is ultimately reached that it is worth conserving, a few general outlines of possible solutions to some of the major problems have been suggested. It should be evident that much work is involved if there is to be any real hope of survival for the business, and that it is never too early in the life span of the owners to begin a careful and systematic planning program, carried out consistently over the years ahead.

Norman Edward Webster

By THE COMMITTEE ON HISTORY

Norman Webster well earned the title of Historian of American Accountancy. His patient, tenacious exploration of every possible source of facts about accountants and their organizations has greatly enriched the literature of the profession.

His approach to history was essentially biographical. He believed fully that every lasting institution is the lengthened shadow of a man. History, to him, was the story of the lives of persons, both natural persons and the artificial persons that live in the form of associations or societies.

A reason for this—perhaps *the* reason—is that he was always a man of friendships. To him, human contacts were necessary. People were what he thought, talked, and wrote about.

He knew that progressive developments of accountancy were expanding the basic concept of the accountability of stewardship into areas where accounting controls were aiding modern management of enterprises of all sorts to shape their day-to-day progress. He was fully aware that new methods of record-keeping and new mechanical devices provided modern tools for the

modern accountant which were not known to the founders of our accounting associations. He knew that other historians should, and probably would, in time, write the story of these developments. He urged his friend A. C. Littleton to carry on the work he had begun with his *Accounting Evolution, to 1900*. But Norman Webster knew that, for him, the search for facts, forgotten or never formally recorded, about those men who began the building of professional accountancy, was both a vocation and an avocation.

Historical Works

His first published historical work was *The Ten Year Book* of the New York State Society of Certified Public Accountants. For the first ten years of the existence of the Society there was no connected and coherent record of activities. Thereafter there was an annual succession of *Year Books*. Mr. Webster set himself the task of assembling all possible data relating to Society activities during the initial decade and of arranging them in narrative form.

The success of this effort imposed on his active mind the idea of a similar history for the national association of professional accountants. That aim was realized in 1954, when the American Institute of Accountants published his volume *The First Twenty Years of The American Association of Public Accountants*. The preparation of this work took much more time, much more ingenuity, and very much more by way

In preparing this article, the Society's Committee on History (Jennie M. Palen, Chairman) was provided with material by Henry A. Horne, C.P.A., a past President of our Society and one of Mr. Webster's partners.

of correspondence and personal interview than the earlier volume for the New York State Society.

Many of his writings have appeared in the magazines of the profession. His address presented at the Fiftieth Anniversary convention of the American Institute of Accountants was published in *The Journal of Accountancy*. Of the twenty-two historical articles that have appeared to date in *The New York Certified Public Accountant* eleven were the work of his hand.

Family Background

Born in the small village of Decatur, Michigan, on March 26, 1869, he thought of himself always as a son of "the Middle Border". His father, Norman Earl Webster, was a carpenter. The family was part of a farming community, though not actively sharing in agriculture. During all the long years of his maturity which were lived in Washington and New York, he never lost his appreciation of his early years in rural surroundings.

His mother, Jennie Chavileer Webster, was a small, active, vivacious woman and her only child inherited largely from her. Both parents were descendants of early American families. The Webster family came to New England early in the seventeenth century, moved to Vermont, to New York State, to Ohio, and on to Michigan. The Chavileer family was believed to be of the French Huguenot migration to the New World. Probably the name was "Chevalier" originally, the altered spelling being a conformance to the accepted pronunciation.

Religious Affiliations

The family were members of the Presbyterian Church, the father holding an office as a layman in the local con-

gregation. Norman Edward Webster became a member of the church in Decatur. He was transferred later to a church in Kalamazoo and still later to the Church of the Covenant in Washington, D.C. That church and congregation is now known as The National Presbyterian Church and is the church attended by President and Mrs. Eisenhower.

In the last year of his life he joined the New York Collegiate Church of The Reformed Church in America, West End congregation, a church with a Presbyterian form of government, the oldest church organization in New York, and probably the oldest Protestant church organization in the Western Hemisphere. All these features appealed strongly to Norman Webster's veneration of the old and to his affection, through tradition, for the Presbyterian polity.

Early Education and Training

His early education was received in the Decatur Graded School, which carried him through what are now known as "the grades" and also into "secondary school" studies, which now would be defined as those of high school rank. In that school he came under the influence of a man of strong character and high ideals, a Professor Henry Upton. Professor Upton's impact on the life of the boy Norman Webster continued until the end of life. Another teacher of that country school who left a strong impression on him was Miss Abigail Pierce. Apparently the bright, fun-loving boy was a favorite with both of these early teachers.

At the end of his schooling he was employed as a clerk and as a bookkeeper, by the Decatur Manufacturing Company. In various job changes his pay-check came successively from Hinckley Stave Company and Michigan

Buggy Company. At that time (1885-1893) Michigan industry was based largely on lumbering and wood-products. The manufacture of wooden horse-drawn vehicles was the field in which Norman first learned about business.

Early in 1893 he procured a scholarship to Union College, Schenectady, New York. He attended for one semester and was inducted into the mysteries of Beta Theta Pi. At the opening of the summer vacation season he learned that he could get employment at the Chicago World's Fair—The Columbian Exposition. The work of that summer fastened in his mind the need for financial auditing as well as some of its techniques. His duties required him to obtain sales data from the polygot concessionaires in the exposition grounds. As Bret Harte's phrase has it "For ways that are dark and tricks that are vain" Well—young Norman learned a few tricks, also.

Government Service

At the close of the exposition, one of Norman's boyhood friends who had secured a civil service position convinced him of the advantages of work in Washington. Young Webster took an examination, gave up the idea of completing his college course, and became a bookkeeper in the office of the U. S. Treasury Department that had the responsibility for the audit of the Post Office Department. He had been employed in the Treasury Department office for over ten years when he learned that a new position was to be created in a relatively new bureau in the Department of the Interior. During the administration of Theodore Roosevelt it became apparent that there were large areas of our western states which could be rendered fertile and productive if water could be made available. The

U. S. Reclamation Service undertook to provide the water, and in so doing it found that some accounting knowledge was needed. An examination for the position of Chief Accountant was prepared by the Civil Service Commission. Mr. Webster took the examination and was the successful candidate. During the succeeding six years he traveled over much of the West, planning for and supervising the financial transactions of the Reclamation Service.

Incidental to his work for this organization he took, successfully, the first CPA examination given in the State of Michigan. He was one of the first group of Michigan CPA's. He could not be "Number One", because his name places him close to the end of any alphabetical listing.

While in the Reclamation Service he was named a member of a committee of conference with a committee from the American Association of Public Accountants, which had been asked by President Theodore Roosevelt to examine and report on certain governmental administrative functions. These conferences brought him into friendly contact with some of the leading professional accountants of the day. Particularly, he cherished his acquaintance with Arthur Lowes Dickinson, Elijah Watt Sells, and Henry Anderson Niles.

Professional CPA Practice

Mr. Niles offered him a partnership in the firm of Niles & Niles in New York. Aware that the bringing in of a partner from the outside would have a disrupting effect on the morale of the staff, Mr. Webster accepted on the condition that he be permitted to be a staff employee for one year. A year later, on January 1, 1911, he began a partnership relation that was to last more than sixteen years.

Norman Edward Webster

The change of residence from Washington to New York meant a severing of relationships built up during sixteen years. On December 17, 1895, his childhood sweetheart, Rose Rezeau, became Mrs. Webster. They had been together for almost sixty years when she died on May 25, 1955. Mr. and Mrs. Webster had been active in the Christian Endeavor Society of the Church of the Covenant, in Washington. The Reverend Doctor Teunis Hamlen, an alumnus of Union College, was the minister of this church. He took a strong liking to the young Websters. Knowing of Norman's attendance at Union and being desirous of beginning, in Washington, an Alumni Society for the sons of Union College and a University Club for all college men living in the city, he pressed Norman into service as his administrative assistant. As a result, Norman Webster was one of the founders of the University Club of Washington, continuing his membership until the day of his death.

The Washington years were put to good use. Evening attendance at National Law School earned for him his bachelor's and his master's degrees (LL.B.; LL.M.). He was admitted to the bar of the District of Columbia. He was active in the organization of the Association of Government Accountants and was elected to its presidency. His success in the discharge of his various governmental duties, his activities in alumni and university matters, and (probably) the friendship of Doctor Hamlen, caused his Alma Mater, Union College, to bestow on him the honorary degree of Master of Arts (A.M.).

In New York City a new career began. He presented himself for the New York CPA certificate and was successful in all subjects on his first examination. In later years he was a member of the New York State Board of CPA

Examiners and for most of his long term of office was Chairman of the Board.

Participation in Professional Societies

His period of active participation in professional public accountancy, which began in November, 1909, included many important engagements involving large financial affairs. During that period, also, he gave of himself liberally to the work of the professional societies. In the American Institute of Accountants he was a vice-president and a member of council, in addition to long years of service as Chairman of the Committee on History. In the New York State Society of CPAs he was a vice-president, a director, and, for many years, a member of its Committee on History.

On May 1, 1927, with a small group of fellow accountants, all old friends, he organized the accountancy firm now known as Webster, Horne & Elsdon, then with offices in New York and in Hartford, Connecticut.

During the Second World War he was asked to lend his prestige and support to the war effort and was appointed to be the Chief Supervising Auditor of the Third Naval District, whose headquarters were in the Port of New York.

The Chapter of Beta Alpha Psi at Syracuse University made him an honorary member of the fraternity and of that Chapter. It is fair to say that Mu Chapter of New York University had adopted him also.

The opening of the office in Hartford suggested application for a Connecticut CPA certificate, which was granted promptly. The Connecticut Society of CPAs welcomed him as a member. The University Club of Hartford also brought him into its fellowship.

When The Accountants Club of

Norman Edward Webster

America was organized he became one of the charter members. Later, for five years, he was president of the club, a position for which he was by temperament particularly adapted.

Soon after the organization of the National Association of Cost Accountants in 1919, he became and remained thereafter an active and interested member of the association and of its New York Chapter.

For many years and until his death he was a member of the American Accounting Association, which succeeded the former Association of University Instructors in Accounting.

He was one of the group that organized the National Association of Certified Public Accountant Examiners and he remained actively interested in that association continuously thereafter.

His membership in the Michigan Association of CPAs was continuous from the date of its organization until the end of his life.

Cultural and Social Interests

Though history was his dominant interest, it was not his only one. He was one of the earliest members of the National Geographic Society, having joined it in Washington in the 1890's. He was also a member of the American Geographical Society of New York. His cultural instincts led him to membership in The Metropolitan Museum of

Art and The American Museum of Natural History. As might be expected, he was an interested and active member of The New York State Historical Society and of The New York Historical Society of New York City. In New York City he was a member of the Lawyers Club. In the country he enjoyed membership in the Sleepy Hollow Country Club, in the area that is full of the memory of Washington Irving. In political affiliation he was a Republican.

A Full and Rewarding Life

After the death of his wife in May, 1955, Mr. Webster's health failed substantially. In January, 1956, he had a severe illness, primarily pneumonia, but seriously complicated by a chronic heart weakness. Thereafter he could not recover strength. Continuous medication sustained him until July 15, 1956, when, without pain or struggle, in the eighty-eighth year of a full and rewarding life, he died.

His library of accountancy history materials he gave to the American Institute of Accountants Foundation, with the intention that it should be available at the library of the American Institute of Accountants. His personal library will go to a library in his native village of Decatur, Michigan. His will provides that the residuary estate be used for the building and maintenance of that library.

New York State Tax Forum

Conducted by BENJAMIN HARROW, C.P.A.

Optional Deduction . . . Filing Date of Income Tax Returns . . . Exemptions under the U.B.T. Law . . . Franchise Tax on Business Corporations . . . Head of Family . . . Reduction of Taxes on Unincorporated Businesses . . . Special Deduction to Physically Handicapped Individuals . . . Deduction of Necessary Expenses of Child Care . . . Credit for Taxes Paid to Other States . . . Deduction for Federal Income Tax . . . Definition of Capital Assets . . . Deduction for College Tuition.

Optional Deduction

A taxpayer may deduct ten per cent of his gross income or five hundred dollars, whichever is less, in lieu of all deductions. This has been interpreted to mean that the use of the optional deduction prevents a taxpayer from taking proper business deductions. In our opinion that was not the intention of the law when it was enacted in 1947.

BENJAMIN HARROW, C.P.A., has been a member of our Society since 1928, and a member of the American Institute of Accountants since 1922. He is a member of the New York Bar and Professor of Law at St. John's University.

Mr. Harrow is a past Vice-President of the Society. He is a member of the Society's Committees on Meetings and Committee Operations, and had served for a number of years on the Institute's Committee on Federal Taxation.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

A number of bills in the present legislature attempt to correct this. One bill does it by providing as follows: "Notwithstanding the foregoing provisions . . . and in addition to the optional deduction hereby provided, any taxpayer may deduct such amounts as are allowable to and allowable in connection with a trade, business, or profession carried on or conducted by the taxpayer, including the rental of real property". Another bill provides that this amendment shall be applicable to returns filed for any year commencing on or after January 1, 1957.

Filing Date of Income Tax Returns

Under the present law, returns must be filed by the 15th day of the fourth month following the close of the fiscal or calendar year. Following the federal law which several years ago extended by one month the due date for filing individual income tax returns, bills have been introduced to extend the due date of state returns by one month. The Tax Commission will probably oppose the

bill because it would interfere with the budget year.

Exemptions under the U.B.T. Law

The law exempts from the tax the practice of law, medicine, dentistry, and architecture "which under existing law cannot be conducted under corporate structure . . ." The law also exempts any other professions in which more than 80% of the gross income is derived from the personal services actually rendered by an individual, and in which capital is not a material income producing factor.

This latter provision has been the source of much litigation over the meaning of the word *profession*. A bill has been introduced which will have the effect of enlarging the exemption by making the latter provision applicable to occupations as well as professions.

The fate of this bill will be awaited with much interest.

Franchise Tax on Business Corporations

Under the present law the tax is computed under one of four bases, the minimum tax being \$25.00. A bill has been introduced to reduce the minimum tax to \$20.00. That should be helpful to inactive corporations.

Head of Family

This concept is similar to what is called head of household under the Internal Revenue Code. A bill has been introduced which allows a taxpayer to consider himself a head of family if he "maintains a *household* which constitutes the principal place of abode of his father or mother", if either one is a dependent of the taxpayer. Presumably, this added provision is intended to conform the state law to the federal Code, which does not require dependent par-

ents to live in the taxpayer's home as long as the taxpayer maintains their household.

Reduction of Taxes on Unincorporated Businesses

Several bills have been introduced to reduce the unincorporated business tax. One bill would reduce the tax by 15% of the first \$100 and 10% of the next \$200. That is similar to the reduction under the personal income tax law for 1955. A bill has been introduced continuing this credit for the year 1956. As of March 4th, this bill was passed by the legislature.

Another bill would allow a credit of the first \$100 of tax. As the bill puts it, "such credit shall be reduced by the amount that the tax . . . exceeds \$100."

Special Deduction to Physically Handicapped Individuals

A bill has been introduced allowing a deduction of \$600 to disabled individuals. Such a person is defined as an individual who by reason of a physical defect or infirmity (congenital or acquired) is handicapped during the entire year so that he is faced with extreme limitations with respect to employment and social activities. The law is to be applicable for years after January 1, 1957.

Deduction of Necessary Expenses of Child Care

Under the Internal Revenue Code a maximum deduction of \$600 is allowed to working mothers or widowers who must pay others to care for their children in order that they may earn a living. The State presently has no similar provision. A bill has been introduced allowing as a deduction any expense incurred for the care of children where such care is necessary for the production of income. What the bill does is to

treat such an expense like any other ordinary and necessary business expense. It is doubtful whether the Tax Commission will approve such an unlimited deduction.

Credit for Taxes Paid to Other States

A much needed provision has been introduced in a bill to allow a credit for income taxes paid to another state. A proportionate part of such tax would be allowed based upon the ratio of income subject to tax in such state to the entire income subject to tax in this state. The credit is not to be allowed if the other state allows a credit to the non-resident for the tax paid to New York. Furthermore the allowance of the credit may not reduce the tax to an amount less than would have been payable if the income from the other state were excluded from net income.

In other years the State Tax Commission has opposed such a credit. Perhaps it will now see the wisdom of limiting the double tax on such income.

Deduction for Federal Income Tax

Each year, taxpayers and their representatives raise the question of allowing some deduction from gross income for federal taxes. This year is no exception. A number of bills have been introduced providing for some such deduction. One bill would allow a deduction of 2/3 of any federal income taxes paid. This bill would make the law applicable to returns for years after January 1, 1957. Another bill would limit the deduction to 25% of the federal income tax and make it applicable to returns for years after January 1, 1956. A third bill would allow a full deduction for federal income

taxes. Still another bill would limit the deduction to \$500.

Definition of Capital Assets

Under the Internal Revenue Code, business real estate or depreciable business property is excluded from the definition of capital assets. However under a special provision in the Code a gain on the sale of such property if held for more than six months is treated as if it were a long term capital gain although a loss is treated as an ordinary loss. No similar provision is contained in the State law.

A bill has been introduced that would follow the federal law. Like the federal law, this bill would subject involuntary conversions to similar treatment. Like the federal law the bill includes livestock held for draft, breeding, or dairy purposes (but excluding poultry), held for twelve months or more from the date of acquisition. Unlike the federal law, the gain on timber or coal is not given preferential capital gain treatment.

Deduction for College Tuition

A bill has been introduced that would allow a deduction up to \$500 for tuition paid at a college for each dependent child.

Another bill would allow an exemption of \$800 for a dependent over 18 years of age and in full-time attendance at an approved school or college.

Another bill would allow a deduction not over \$500 for tuition paid by a teacher in elementary or secondary schools for higher educational study required by the education law or pursued for the purpose of increasing teaching efficiency or maintaining or renewing a license.

Accounting at the SEC

Conducted by LOUIS H. RAPPAPORT, C.P.A.

SEC Decision in Ultrasonic Corporation Case (Securities Act Release No. 3742, January 18, 1957)

The decision of the SEC in the Matter of Ultrasonic Corporation is reprinted in full below, except for omissions which are of no accounting interest.

This is a proceeding under Section 8(d) of the Securities Act of 1933 to determine whether a stop order should issue suspending the effectiveness of a registration statement filed by Ultrasonic Corporation ("registrant"). The registration statement was filed on June 28, 1954, and covered 200,000 shares of common stock to be offered at \$12.75 a share; warrants to purchase 89,154 shares of common stock at \$10 a share, to be offered in exchange for outstanding warrants plus \$2.75 for each share covered by a warrant; and 216,054 additional shares of common stock issuable on the exercise of the warrants and the conversion of certain outstanding bonds and debentures. The registration statement became effective July 22, 1954, and the 200,000 shares of common stock offered for cash were sold to the public shortly thereafter. On August 23, 1954, registrant filed a post-effective amendment reducing the offering price of the warrants to 75¢ a share and increasing their exercise price to \$12 a share. This amend-

ment was declared effective on August 25, 1954.

After appropriate notice, hearings were held before a hearing examiner. Registrant and the Division of Corporation Finance ("Division") submitted proposed findings and briefs in support thereof, and the hearing examiner filed a recommended decision recommending that a stop order issue. Exceptions to the examiner's recommended decision and briefs were filed by registrant and the Division, and we heard oral argument.

The issues in this proceeding relate primarily to the net income figure set forth in the prospectus included in the registration statement, which showed a profit of \$49,715 for the six months ended March 31, 1954.¹ That figure was reflected in an interim statement for the period which was unaudited, although an accounting firm which had conducted registrant's previous audits assisted in the preparation of the registration statement. The Division contends that that figure is about \$900,000 in excess of the amount which should have been shown because registrant made various improper adjustments in its records, particularly with respect to profits from contracts in process and costs of sales, and failed to make other

LOUIS H. RAPPAPORT, C.P.A., a partner in the firm of Lybrand, Ross Bros. & Montgomery, C.P.A.s, is the author of SEC Accounting Practice and Procedure.

Accounting at the SEC

adjustments that should have been made.

The Division also urges that the prospectus is deficient in failing to disclose losses incurred for the months of May, June and July, 1954, which it contends amounted to approximately \$800,000. Registrant's annual report for the fiscal year ended September 30, 1954, which was issued after the 200,000 shares of stock had been sold and contained financial statements audited by another accounting firm reflecting many of the write-offs and other adjustments claimed by the Division to have been required in connection with the March 31, 1954 figure, showed a loss for the 1954 fiscal year of \$3,324,724.

At the time the registration statement was filed registrant was engaged in the production of products which may be divided into three general categories. One division made electronic equipment, chiefly under contracts with the United States Government. Another division, called the Monitor Division, made electrical motor controls and switchgear used to regulate the flow of electric current. A third division had recently commenced the production of air-conditioning equipment. An indication of the relative importance of the three divisions can be derived from the statement in the prospectus that the estimated backlog of orders as of June 30, 1954, amounted to \$5,000,000 in the Electronics Division, \$1,200,000 in the Monitor Division and \$168,000 in the air-conditioning field. Registrant had been engaged in the development and manufacture of electronic equipment for the Department of Defense since its organization in 1945. The Monitor Division was an outgrowth of the business of Monitor Controller Company which registrant acquired in April 1952 and expanded to include switchgear and similar more elaborate equip-

ment. Late in 1953 registrant acquired a new building in Cambridge, Massachusetts, enabling it to move the Monitor Division from its then location at Braintree, Massachusetts, and concentrate all of its activities, which had grown considerably, in one place.²

In 1953 the Electronics Division was employing a job cost system for computing its cost of sales. This system was subject to check by United States Government representatives in connection with the contracts with the Department of Defense and was considered substantially accurate. The Monitor Division was not using a cost system and, in October 1953, registrant decided to install such a system to be effective beginning as of the close of the fiscal year ended September 30, 1953, as of which date an audit had been made and a physical inventory taken. Trained personnel were employed for this purpose and began the development of a cost system for the Monitor Division shortly after the start of the 1954 fiscal year. The installation of the system encountered some difficulties, due principally to the delay in getting time and material tickets into the accounting department. Although there was some difference of opinion among various witnesses as to the reliability of the system, the comptroller and his assistants, who were experienced in accounting matters and closest to the operation of the system, considered it had become reasonably reliable by December 1953 and was being improved and brought more current.

In January 1954 it was possible to prepare a statement showing the results of registrant's operations for the three months ending December 31, 1953 using this cost system. In preliminary form this statement showed an operating loss of \$223,661. Thereupon the following four adjustments were made

Accounting at the SEC

pursuant to so-called "management" policies which transformed this loss into a profit of \$46,858.

First, estimated profits in the amount of \$109,904 on a government contract in the Electronics Division, called contract No. 174, were included in the income account. It was estimated that the profits on this contract would amount to \$298,943, that at December 31, 1953, the project was 44.6% complete and that the profit to that date at that percentage would be \$133,328. Of this amount, \$38,928 had previously been recorded in the books as profit recognized under progress billings, and the balance, after some minor adjustments, was then recorded. At the time there were about thirty contracts in process in the Electronics Division, and although registrant contends that this contract had unique features, particularly in that it was not subject to price redetermination, we do not consider that registrant was warranted in singling it out for special treatment with respect to the recording of estimated profits. A similar review of all the contracts would have shown that the inclusion of estimated profits on one particular contract was improper. For example, another contract then in process, called contract No. 122, was a profitable contract which was subject to price redetermination and later the income accounts were adjusted downward by \$107,996 to provide for such redetermination. This contract was in about the same stage of completion at December 31, 1953, as it was when the downward adjustment as to it was made, and if it had been reviewed as of that date and proper allowance been made for price redetermination the estimated profit on contract No. 174 would have been almost entirely offset by this one item alone.

Second, an amount of \$68,352 was deducted from cost of sales representing "charges for unproductive effort" of direct labor because of the moving of the Monitor Division from Braintree to Cambridge. This amount was arrived at by taking 50% of the direct labor costs for October 1953 and 75% of such costs for the months of November and December, and was in addition to some \$40,000 charged to deferred moving expenses determined by time cards records of direct labor used in connection with the moving. All of registrant's top accounting officers and the accounting firm which assisted in the preparation of the registration statement either objected to or questioned this adjustment, and none of registrant's officials in positions of responsibility and authority who testified about this matter was able to explain who authorized the use of these percentages or how they were arrived at. It is clear that this adjustment was arbitrarily arrived at and was improper.

Third, deductions were made from various expense accounts amounting to \$21,310 for payrolls of supervisory and service employees in connection with the move. This entry is likewise without support.

Fourth, \$94,602 of engineering expenses was excluded from costs of sales and included in an account labelled "Work in Progress—Engineering", to be deferred over a one-year period. This amount was reduced by one-fourth or \$23,649 as amortization for the three months period ended December 31, 1953, leaving a net reduction of sales cost of \$70,953. The accounting officers of registrant thought that the expenses should not have been deferred, and the propriety of treating this amount as a deferred item in this manner is questionable.

The
rived
ended
appro
period
profit
ber 3
that t
purpo
lowing
ilar m
fit fig
of sh
tions
proxim
of 5.1
adjust
another
Electro
of a p
mated
additi
Monito
Furt
books
counts
had be
for the
31, 19
ary, 19
into its
April,
a cost
which
formul
ed cost
for the
1954, o
putation
cost of
mined
cost b
more th
There
a source
counts
system

Accounting at the SEC

The \$46,858 profit figure thus arrived at for the three-months period ended December 31, 1953, represented approximately 5.1% of sales for the period, which was close to the 5.2% profit in the fiscal year ended September 30, 1953, and the record indicates that the adjustments were made for the purpose of achieving this result. Following this, other adjustments of a similar nature resulting in increased profit figures were made for the purpose of showing that the results of operations during January and February approximated the desired range of profits of 5.1% or 5.2% of sales. Among such adjustments were the singling out of another government contract in the Electronics Division and the recording of a profit thereon on the basis of estimated completion, and the deferment of additional engineering expenses in the Monitor Division.

Further major changes in registrant's books were then made. The cost accounts in the Monitor Division, which had been written into registrant's books for the three months ended December 31, 1953 and for the month of January, 1954, were not thereafter written into its books and, about the middle of April, the books were rewritten to show a cost of sales for the Monitor Division which was computed on the basis of a formula of 77.3% of sales. The adjusted cost of sales for the Monitor Division for the six months ended March 31, 1954, on the basis of this formula computation, was \$744,175. The actual cost of sales for this period as determined by the comptroller from the cost books was \$936,434, \$192,259 more than the adjusted figure.

There does not appear to have been a sound basis for writing the cost accounts out of the books. Although the system had been in use for only a rela-

tively short time and there remained problems to be resolved before it could be considered thoroughly accurate, the comptroller, his assistants and other accounting personnel considered it reasonably reliable under the circumstances.

Also, the use of the 77.3% figure in the formula was entirely unjustified as there does not appear to have been sufficient actual support in the experience of the registrant for the selection of that percentage amount for use in estimating the ratio of cost of sales to sales.

We recognize that it is an accepted accounting procedure under some circumstances to use a percentage of sales to estimate costs of sales until actual costs can be determined. However such a percentage should be based on recent operating experience under comparable conditions. The record shows that the 77.3 percentage was determined on the basis of the relationship between sales and costs of sales for the period from February 1, 1952 to December 31, 1952, and that the use of such percentage was entirely unrealistic from several points of view. The experience after December 31, 1952, was ignored. The relationship between sales and costs of sales for the fiscal year ended September 30, 1953 was 83%. In that year there were wage increases of about 15% which were reflected in costs, and in the latter part of the year the transfer of the Monitor Division from Braintree to Cambridge took place. After the close of the 1953 fiscal year the Monitor Division began substantial production of switchgear and motor control centers, which were a substantially different type of product from the motor controls previously manufactured. These changes and other differences in operating problems made the 1952 figures a remote and unreliable standard. But, most importantly, the

Accounting at the SEC

results of operations after September 1953 based on actual costs were disregarded. The actual cost of sales for the three months ended December 1953, as shown by registrant's books, was 90.1% of sales. Moreover, the management had data showing that the manufacturing costs of shipments made in the Monitor Division during these three months was 100.9% of the sales value and for the six months ended March 31, 1954 was 116.7% of sales value. The 77.3% figure was beyond the limits of any reasonable judgment and can only be explained by a desire to show a profit.

When the income statement for the six months ended March 31, 1954 was drafted it showed a tentative profit which, by reason of the distortion resulting from the use of the 77.3 percentage method of computing costs of sales in the Monitor Division and previous adjustments, was considerably in excess of the intended 5.3% of sales. Accordingly, the tentative profit of \$184,019 was written down to \$129,599, an amount corresponding to 5.3% of sales, by transferring \$54,420 from "Work in Progress—Engineering" to cost of sales.

The Division urges that the statement of income for the period ended March 31, 1954, should have been reduced by providing for reserves in the total amount of \$317,435 in respect of contracts in registrant's Electronics Division, including a reserve for profit adjustment in the amount of \$192,029, a reserve for additional losses of \$28,334, and a reserve for redetermination of profits on contract No. 122, discussed above, of \$97,072. We agree that the suggested adjustments should have been made. The need of a reserve for profit adjustment arose from the fact that part of the profits on vari-

ous uncompleted contracts had been entered into the books from time to time without regard to current operating results indicating that substantially lower profits or losses would be realized on the contracts. We have noted above how the estimated profit on contract No. 174, a particularly profitable contract, was improperly singled out for inclusion in the accounts. A number of other contracts had been accorded similar treatment and there was a need for a complete review which, had it been made, would have disclosed the need for a reserve for additional losses. The need for a reserve to provide for a redetermination of the profits on contract No. 122 should have been particularly apparent.

It is clear from the foregoing that the statement of income for the six months ended March 31, 1954 was substantially inaccurate and misleading. We conclude that the record supports the Division's contention that the \$49,715 profit figure was at least \$900,000 in excess of the amount that should have been shown.³ Although registrant might have arrived at a different figure by the use of other permissible accounting treatments it is clear that under any sound accounting procedure a very substantial loss rather than a profit would have been shown. The record shows that the numerous adjustments and omissions produced completely unrealistic financial statements and were the result of a deliberate design to present optimistic figures rather than of the exercise of reasonable accounting judgments.

Much of the action in question was taken over the objections or contrary to the suggestions of the comptroller and his assistants, who were qualified for their responsibilities, and, as above

Accounting at the SEC

stated, experienced in accounting matters and closest to the operation of the accounting system. Most of the adjustments were made pursuant to the direction of the financial vice-president who knew the true situation. Reports were given periodically to the president and the evidence shows that he knew of and approved much of the action taken.

On April 15, 1954, a vice-president of registrant who was at the time the head of the Electronics Division and chairman of the executive committee of the operating management, wrote to the president a detailed memorandum setting forth his views on the condition and prospects of registrant. Among other things he said "If I have the picture straight, the company is faced with short-term obligations of approximately \$2,500,000 together with current operations which are rapidly adding to these obligations and at the same time accumulating an annual picture that will make our next audited statement look like a hurricane struck (something like \$2,000,000 loss on \$7,000,000 billings)." The former comptroller of registrant, an experienced certified public accountant who resigned on April 30, 1954, because of disagreement with the management's accounting policies, submitted a memorandum dated April 15, 1954, entitled "Comments on Balance Sheet at March 31, 1954" stating "This Balance Sheet has been prepared in accordance with policies established by the President of the Ultrasonic Corporation. A surplus is shown on this Balance Sheet. The Assets include items which are not acceptable on the basis of sound accounting principles as follows:" He then listed five items totaling \$1,058,643 and explained them in some detail. Much of this excess resulted from failure to include amounts in costs of sales.

Registrant asserts that it relied upon a letter obtained by it from the accounting firm which assisted in preparing the registration statement as approving the accounting action taken. The record shows that the wording of this letter, which dealt with the unaudited financial statements for the period ended March 31, 1954, was arrived at by those accountants after discussions with the attorneys employed at the time in connection with the preparation of the registration statement. During their review of registrant's books the accountants had questioned various matters and had made several suggestions that were disregarded. The letter in its final form noted that the accountants' review and investigation had been limited and that they did not have sufficient information on some of the matters, was further qualified in various respects which we think are clearly in the nature of exceptions to the opinions expressed therein, and specifically stated it was not to be used or referred to in the registration statement or offering literature. It is clear that the letter could not relieve registrant from its responsibility for the accuracy of the information in the registration statement, including the financial statements.

Counsel on behalf of registrant have urged that the statement of earnings was not material in this case, suggesting that this was a "growth" company and no investor would have purchased registrant's stock on the basis of past earnings. The short answer to this is that an income statement is a specific requirement of the Securities Act and the applicable registration form.⁴ Profits and losses must be stated properly in accordance with applicable standards so that investors will be in a position to form their own judgment as to their

Accounting at the SEC

materiality. Further, although the record in this proceeding does not show exactly what happened to this company after the substantial loss for the year ended September 30, 1954 was published, it indicates that the management has been completely changed, parts of the business have been disposed of, and additional shares of stock have been sold by registrant at \$1 a share.

The failure to disclose a large loss instead of a profit of \$49,715 in the summary of earnings and the financial statement also made several other representations in the registration statement misleading. For example, statements that the proceeds of the offering were to be used for increased working capital required by the expansion of registrant's business were misleading in view of the large operating losses. Also, the disclosures as to continuous growth and expansion of the business and the statement in the prospectus that the business position of the Monitor Division appears well established were misleading in the light of the results of the most recent operations.

Various related statements and footnotes in the financial statements were also deficient. For example, it was stated: "The summary for the 6 months ended March 31, 1954 was prepared on a basis consistent with that of the preceding 5 years and includes all adjustments necessary to a fair statement of the results of operations for such period." From what has been shown above it is clear that this statement was false. Also, it was stated: "The March 31, 1954 inventory was based on the inventory of September 30, 1953, plus increases in inventory at actual cost, minus decreases resulting from sales at actual cost in the Advanced Electronics Division and, in the Monitor Division, at percentages of selling prices determined on the basis of past experi-

ence." Our discussion above shows that the reference to past experience was misleading.

In addition, the registration statement was deficient in that it failed to disclose large operating losses incurred after March 31, 1954. Registrant reorganized its operating procedures on a divisional basis as of May 1, 1954, and apparently no financial reports were issued to management for the month of April. In July the accounting department issued a profit and loss statement for the months of May and June, prepared on a divisional basis and using actual cost figures for the Monitor Division which showed a loss for May of \$251,108 and a loss for June of \$234,696, a total of \$485,805. All three of registrant's operating divisions contributed to these losses. The testimony shows some uncertainty as to the exact date this statement was given to the management but it was about the time the registration statement became effective on July 22, 1954. However the data compiled in the profit and loss statement was available prior to this time and the management is chargeable with knowledge that registrant was incurring large operating losses during this period.

A later statement, prepared on a similar basis, showed losses for May, June and July in the total amount of \$800,182. This statement was given to the management on August 19, 1954, before the post-effective amendment was filed. Other statements based on the general books and the 77.3% formula were circulated at about the same time and showed a loss for the month of June of \$287,904 and a loss for July of \$136,711. The failure to disclose the large operating losses in the period after March 31, 1954 constituted a material omission.

(Continued on page 283)

Ad

A fo
aspe

Cond

Cre
Fin

Creat

The
staten
can b
reade
comp
on o
audit
staten
reflec
peten
to wi
curate
figure

Ob
cerne
cial s
world
are th
sional

MAX
forme
Admin
of the
fied P
at Th
the g
Practi
firm o

Administration of a CPA Practice

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

Creative Writing vs. Copying in Reports . . . Pencil Copy Interim Period
Financial Statements . . . Successful Negotiating With Client Prospects.

Creative Writing vs. Copying in Reports

The material appended to financial statements, particularly annual reports, can be as important and helpful to the reader as the figures. This material comprises the accompanying comments on operations and financial position, audit procedures, and footnotes to the statements. How well they are written reflects the writer's capacity and competence as an accountant, and his ability to wield the English language as accurately, lucidly and logically as the figures in the financial statements.

Obviously, every practitioner is concerned about the quality of his financial statements because to the outside world, as well as to his clients, they are the visible evidence of his professional status. In a desire to attain a

high level of quality, and to maintain it, staff men have been encouraged, in many instances, to utilize standard forms of expression and, more seriously, to utilize prior reports as a guide to the comments and footnotes in each succeeding annual report.

This policy is acceptable to staff men because it reduces materially the requirement to think about what should be commented on and how to phrase it, particularly when time is short. Since, it seems, time is always inadequate the tendency to copy is widely prevalent. The result, unfortunately, is the failure to develop report writing ability and imagination by exercising it, to cause it to wither where it may have existed, and it is conducive to oversights of substantial and highly noteworthy disclosures. Moreover, hasty copying may result in the presentation of data that should have been revised or eliminated and a reviewer may not necessarily detect such situations, particularly when he too is under time pressures.

The moral of all this is that practitioners should insist that comments be written out completely as new, except with respect to the mere transmittal

MAX BLOCK, C.P.A. (N. Y., Pa.) is a former chairman of the Committee on Administration of Accountant's Practice of the New York State Society of Certified Public Accountants. He is a lecturer at The City College of New York in the graduate course on Accounting Practice. Mr. Block is a member of the firm of Anchin, Block & Anchin.

portions of a letter, the opinion or disclaimer, and other judiciously selected portions. While a prior report should be referred to, just to learn what it contained, that is not license to reproduce it with only changes in dates and figures. Some compromising may be in order in the case of small, non-varying operations, as, for example, the ownership of real estate rented out on a net lease basis. Otherwise we must provide the time for staff members to indulge in creative, practical report writing and financial statement presentation.

Pencil Copy Interim Period Financial Statements

The following letter from Harold Stern, CPA, is reproduced because it is a case record of a practitioner's experience with pencil copy financial statements.

"I read with interest, in your department, in the January issue of the magazine of pencil copy interim reports.

"For some time now, with certain of our clients, we have been using pencil copy interim reports. We have been setting the statements up in columnar form on 14 column worksheets. By use of this method we have the 12 monthly interim statements all in one place, and readily available for quick reference.

"We have employed this only where the statements were for the use of internal management only. When a statement is required, at year end, or perhaps at another date, for third party use, we submit typed formal reports.

"Our experience has been very happy with the pencil figures. The client generally is enthusiastic about the presentation, and is quite taken with the availability of all of the monthly figures in one place."

Successful Negotiating With Client Prospects

In last month's column there was a discussion of fee negotiations and the effect of personality characteristics on the outcome. The same considerations bear on the ability to successfully negotiate with a prospect to make a client of him. The ability to sell the firm or the individual practitioner to the prospect is a trait that is not possessed by all in equal share. When the prospect discusses his requirements with several accountants, to select one, superior selling ability will tip the scales in favor of the man who has done the best job, other basic factors being relatively equal.

Selling ability is a very broad term and it encompasses a natural bent for promotion as well as characteristics such as maturity, experience, impressive personality, professional status, convincing manner, obvious competence, ability to recognize the prospect's traits and concerns and skillfully handle them, and other pertinent characteristics. Some accountants would be successful negotiators (salesmen) in any field of endeavor. Others, though very competent as technicians, lack that personality flair and gift of natural salesmanship talents.

Practitioners who recognize their own promotional inadequacies, and who are in a position to call on a qualified associate for assistance, should not be unwilling for reasons of pride and dignity to invite assistance. It is the firm's interests that are of primary consideration and if the joint negotiation is skillfully and sensitively handled, there need be no personal embarrassment. Except where partners retain individual claims to clients, or where the prospect is not of sufficient importance, should there be any reluctance. Junior partners also should seek the assistance of the older, qualified partner.

Administration of a CPA Practice

In business it is not uncommon for a salesman to call on his sales manager or even the head of the company to help consummate an important deal. There is similar validity in public accounting. This policy has the further advantage of permitting another partner to evaluate the client from the viewpoint of the accounting firm's policies. Many reasons can be found for bringing an associate into a discussion. For example, one may have more experience in the industry of the prospective client, or he may have contacts that may be more helpful in a particular situation, or he may be expert in cost systems, taxes and so forth.

In the application of such procedures some problems may arise. Younger partners may strain at the leash to test their promotional talents. Or, the associate negotiator may, because he is a very vibrant and forceful personality, needlessly lower the status of his associate by unwitting remarks or conduct. These situations, and others not mentioned, need not be insurmountable obstacles. They are merely another facet of personal relations problems and they can be solved by discussion and a sincere will for good relations.

Comments by readers on this subject are solicited and will be publicized.

Accounting at the SEC

(Continued from page 280)

Registrant urges that a stop order should not be issued because the stock issue was sold before these proceedings were instituted, the management has been completely changed, and the future prospects of registrant might be impaired by further publicity about past activities. We do not regard these arguments as relevant to the question of whether a stop order should issue. The registration statement was grossly misleading, investors purchased 200,000 shares of stock in reliance thereon, and the registration statement also covered warrants as well as additional stock issuable upon the exercise of the warrants and the conversion of other securities. The Securities Act contemplates that under such circumstances the effectiveness of the registration statement be terminated regardless of collateral considerations.

A stop order will issue.

References

1. The income figures for the prior fiscal years, which were based on audited financial statements, showed losses of \$126,061 and \$217,181 for the fiscal years ending September 30, 1949 and 1950, respectively, and profits of \$26,908, \$105,441 and \$268,818 for the fiscal years 1951, 1952 and 1953.
2. The prospectus showed that from 1949 to March 31, 1954, the total assets of registrant increased from \$187,323 to \$6,422,262, the payroll increased from 21 employees to 981, and the floor space occupied increased from 6,700 square feet to 254,000 square feet.
3. Questioned items in addition to those discussed above include certain inventory items not written off, capitalized costs not expensed, and expense liabilities not entered.
4. See paragraph (26) of Schedule A of the Securities Act of 1933, as amended, and Item 6 and Instructions as to Financial Statements in Form S-1.

Payroll Tax Notes

Conducted by SAMUEL S. RESS

Jenkins-Keough Bill on Self-Employed Retirement Plans . . .
The Hughes-Ashberry Bill . . . 1957 New York State Experience
Rates Issued . . . Combined Annual Social Security and With-
holding Tax Reports.

Jenkins-Keough Bill on Self-Employed Retirement Plans

The Jenkins-Keough Bill (H.R. 9-10) was introduced in Congress on January 3, 1957. The purpose of the bill is to encourage the establishment of voluntary pension plans by self-employed individuals. It would give self-employed persons a measure of equality with employed persons so far as supplemental private pensions are concerned.

The bill would allow self-employed persons a deduction for Federal income tax purposes for amounts set aside for their retirement, with a proviso that the annual deduction could not exceed the lesser of 10% of self-employment income or \$5,000. However, a special rule would be provided in the case of

persons now 50 years of age or over which would increase the allowable deduction one-tenth for each year of age over fifty but not over age seventy. A self-employed individual could not deduct over his lifetime more than twenty times the maximum annual contribution under the general rule.

The definition of self-employed individual is the same as under the self-employment provisions of the Social Security Act, except that it also includes those not presently covered under such provisions, such as ministers who have not elected voluntary coverage, and physicians. Self-employed persons who also are employed during the year are not disqualified unless they are currently a member of or are receiving payments under a governmental or private pension or profit-sharing plan, or have received a distribution of their interest in such a pension or profit-sharing plan.

The allowable deduction is in terms of amounts paid as "retirement deposits" which are amounts paid into a restricted retirement fund or as premiums under a restricted retirement policy. Earnings realized by a restricted retirement fund would not be taxable until distributed to participants. Restricted

SAMUEL S. RESS, an Associate Member of our Society since 1936, is a member of the New York and Massachusetts Bars. He is engaged in public practice in his own office in New York City specializing in payroll taxation and labor-management matters.

Dr. Ress is a member of the Society's Committee on New York State Taxation and Chairman of its Subcommittee on Unemployment Insurance.

Payroll Tax Notes

retirement policies would include both newly issued annuity, endowment and life insurance contracts, and existing policies. In the case of life insurance policies, no deduction would be allowed for the portion of the premium attributable to the cost of the life insurance protection.

The bill contemplates generally that retirement funds will not be payable until age 65, and would be subject to income tax at time of distribution. Lump-sum distributions would be taxed under a special formula. Withdrawal of the retirement fund, prior to age 65, is permitted subject to payment of a penalty.

The Hughes-Ashberry Bill

There has been presented for enactment into New York State law the Hughes-Ashberry bill "To amend the labor law, in relation to benefit rate, original claim, general account, experience rating and disqualification under the unemployment insurance law". This measure, which would effect basic changes in the law as far reaching as the "Hughes-Brees" law of 1951, has been the subject of a legislative hearing. It appears that even though it may not be enacted in its present form this year, the principles contained in its present provisions, especially those relating to unemployment insurance contribution rate determination, may be the subject of considerable discussion in which accountants may be called upon for their expert opinions.

The Hughes-Ashberry bill (Senate Int. 1763, Print 1851; Assembly Int. 2121, Print 2185) would make these changes in the law:

1. It is proposed to revise the benefit rate schedule and raise the maximum weekly benefit rate from \$36, based upon average weekly wages of \$70 or

more, to a maximum weekly benefit rate of \$45 based on average weekly wages of \$105 or more.

2. The new financing provisions would result in raising the maximum basic rate from 2.7% to 3.8%. In addition, a revised subsidiary contribution provision is included which could result in a new maximum rate of 4% to be effective in 1958.

3. Other provisions call for changes in entitlement to benefits, vacation period benefits and disqualifications.

1957 New York State Experience Rates Issued

Accountants should make it part of their regular audit procedure to determine the correctness of the unemployment insurance contribution rate being assigned currently to the accounts of clients. Excessive charges to benefit accounts and erroneous factors assigned for age, quarterly decreases in remuneration, or annual decreases in remuneration will affect the rate for future years as well as the current year.

Combined Annual Social Security and Withholding Tax Reports

The Jenkins bill H.R. 239 would permit employers to consolidate the quarterly social security and withholding tax reports and file them annually. It would appear that the reasons that existed formerly for quarterly reporting of social security wage information are no longer valid in New York. The present form W-2 contains sufficient information for the establishment of social security wage information to enable the Social Security Administration to do away with the present bulky and cumbersome report required from employers for each quarter.

Federal Income Tax Notes

Conducted by RICHARD S. HELSTEIN, C.P.A.

Timely Filing of Returns . . . Goodwill in the Sale of an Accounting Practice . . . Refund of Damages to Client . . . The Tax Court's Relation to the Circuit Courts of Appeal . . . What Is A *Business Bad Debt*? . . . Elections on Consolidated Returns . . . New Filing Period for Trust . . . Joint Returns . . . Miscellany.

Timely Filing of Returns

Those returns due on April 15th, are required to be *in the hands of the District Director by that date*. Section 7502 IRC 1954, providing that timely mailing is treated as timely filing, specifically excludes returns.

Although the Internal Revenue Service policy has been liberal with respect to returns postmarked the 15th, and even in some cases, the 16th, it is merely administrative grace.

Goodwill in the Sale of an Accounting Practice

Two partners with a successful accounting practice in various cities in the Southwest sold that part of the practice

centered in El Paso to the resident partners. As part of the contract of sale they promised not to compete with the local partners in the area of El Paso.

The Commissioner claimed that the portion of the sales price allocable to the covenant "not to compete" constituted ordinary income. The taxpayers claimed that the covenant "not to compete" merely represented "goodwill". The Commissioner argued that this could not be so since the name of the company prior to the sale was *F. G. Masquelette and Company*, and the sales contract provided that neither this name nor the names of either of the selling partners could be used by the new company. Hence, the Commissioner said, there was no transfer of goodwill and, furthermore, goodwill was never mentioned in the sales agreement.

The Court, in agreeing with the taxpayer that no ordinary income was involved, held:

1. The failure to mention the word *goodwill* is not important.
2. Since the selling partners were professional men, it was understandable that they would not want their names to be associated with the work of others over whom they had no control.

RICHARD S. HELSTEIN, C.P.A., has been a member of our Society since 1940. He has been a member of the Committee on Federal Taxation, as well as various other committees. He is presently a member of the Committee on Publications.

Mr. Helstein has contributed to accounting and other publications, and delivered addresses before our Society and other professional societies. He is associated with J. K. Lasser & Co.

3. The covenant not to compete was not severable from the sale of goodwill, and was simply employed to assure the purchasers that they would effectively enjoy the goodwill. (*Estate of F. C. Masquelette, et al. v. Com.*, C.A.-5, 12/26/56, rev'g T.C., Memo Op.)

Refund of Damages to Client

A taxpayer received a sum of money from her tax consultant which was comprised of three elements: (1) the amount by which she overpaid her tax because of the consultant's error in the preparation of her return; (2) interest on the overpayment, and (3) the fee she paid the consultant for preparing the return.

The Commissioner has ruled that the reimbursement of the overpayment of income tax is not includible in the taxpayer's gross income. (To accord with this ruling, the Commissioner has reversed his non-acquiescence in the case of *Edward H. Clark*, 40 BTA 333.)

He has further ruled that since the fee for preparation of the erroneous return had previously been deducted, its reimbursement was includible in gross income. The interest, of course, is taxable. (Rev. Rul. 57-47, IRB 1957-6, 9)

The Tax Court's Relation to the Circuit Courts of Appeal

The facts in this case are not currently particularly important, since the issue could never result in litigation under the 1954 I.R.C. However, in its decision the Tax Court enunciated a policy which appears to be quite significant.

In the belief that such item was not so includible, the taxpayers did not include in the gross income reported on their joint return, a capital gain which represented more than 25% of gross income. However, they attached to their return a statement disclosing all of the

facts pertinent to the transaction. The Tax Court upheld the Commissioner's assessment which was made over four years after the filing of the return, on the grounds that because more than 25% of gross income was omitted, the five-year statute, under the provisions of Sec. 275(c) IRC 1939, applied. (This decision has no particular current significance since under Sec. 6501(e)(1)(A)(ii), IRC 1954, the attaching of a statement would negate the running of the five-year statute.)

However, in its opinion the Tax Court also stated that where it has been reversed by the Court of Appeals on a decision, and a similar issue arises in another and subsequent case, it must review its position. But if it is convinced its holding was correct, it will follow that decision *even though the second case is to be appealed to the same Circuit Court which previously reversed the Tax Court*, because the Tax Court has national jurisdiction rather than, as in the case of a Circuit Court, a jurisdiction limited to only part of the nation. (*Arthur L. Lawrence et al.* 27 TC ____ No. 82.)

What Is a Business Bad Debt?

A partnership, which was in the business of selling packages of food for shipment abroad, wished to expand its line by adding reconditioned clothing. To this end, it loaned certain sums to a corporation in the metal stamping business with the understanding that the sums advanced were to be used by the corporation to acquire equipment for reconditioning secondhand clothing. The corporation, however, used the loans in its rapidly declining metal stamping business and never acquired any reconditioning equipment. In the year the corporation became insolvent, the partnership claimed a "partial bad debt".

The Tax Court held that the uncollectible portion of the loan was not a *business bad debt* since the partnership was not in the business of buying and reconditioning secondhand clothing at the time the loan was made and because the debtor corporation never did go into that business. Apparently, the intent to expand lines in the same operation was not considered sufficiently *proximate* to the partnership's business to constitute a *business bad debt*.

Nor would the Court allow the deduction as a *non-business bad debt* since that contention was not raised in the pleadings (*Erica Giepen et al.* TC Memo Op. 1957-6, 1/15/57).

Elections on Consolidated Returns

As sole agent for each member of an affiliated group, a parent company filing a consolidated return may make any election with respect to methods of accounting, depreciation, inventories, etc., which could be made by the subsidiaries if separate returns were filed.

However, where in a previous year in a separate return, a present subsidiary had made an election as to the method of computing its income, the parent may not change the election without permission of the Commissioner for purposes of the consolidated return if the subsidiary would have to obtain such permission if it continued to file separate returns (Rev. Rul. 57-20, IRB 1957-3, 7).

New Filing Period for Trust

Where a revocable trust becomes irrevocable upon the death of the grantor, it becomes a new and separate entity

for Federal income tax purposes. Accordingly, the trustee may elect to file the return on the basis of a calendar or fiscal year without permission of the Commissioner, irrespective of the grantor's filing period (Rev. Rul. 57-51, IRB 1957-6,4).

Joint Returns

Where a wife has no income, she has no taxable year. As a result, she and her husband, who reports on a fiscal year basis, may file a joint return. This is so in spite of the fact that the wife, while she was working, had previously filed on a calendar year basis, and had made no application for a change of reporting period. As the Court observes, this result accords with Congressional intent (*Frank E. Bertucci and Ardeth Bertucci v. U. S.*, Ct. Clms. 1/16/57).

Miscellany

The cost of a cocktail bar and furnishings of a rumpus room used in the home for the purpose of entertaining business customers is deductible. But on those items with a useful life of more than one year, it is limited to the depreciation allowable (*Estate of Berthal V. Nottingham*, TC Memo Op. 1956-281, 12/28/56).

A foster mother is not within the definition of "Dependent" under Sec. 25(b) of the IRC 1939 since "... a foster mother is one who has merely performed the duties of a parent to the child of another without any relationship by blood, marriage or adoption ..." (*Robert Frank*, TC Memo Op. 10/25/56).

. Ac
to file
lar or
of the
gran-
, IRB

ne has
e and
fiscal
This
wife,
iously
d had
ge of
erves,
sional
Ardeth
(6/57).

rnish-
home
business
those
an one
iation
Not-
6-281,

n the
r Sec.
... a
merely
to the
lation-
option
o Op.